

ADVISORY | Dodd-Frank Act

December 18, 2013

VOLCKER RULE: FINAL REGULATIONS – PROPRIETARY TRADING PROVISIONS

On December 10, 2013, the Federal Reserve Board, Commodity Futures Trading Commission, Office of the Comptroller of the Currency, Securities and Exchange Commission, and Federal Deposit Insurance Corporation (collectively, the “Agencies”) jointly released long-awaited final regulations implementing section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly referred to as the “Volcker Rule.”¹

The final regulations will become effective on April 1, 2014 and, with the exception of certain reporting and recordkeeping requirements described below, are subject to an extended conformance period ending on July 21, 2015. Each banking entity subject to the Volcker Rule is expected to engage in good-faith efforts appropriate for its activities and investments that will result in full conformance with the Volcker Rule by the end of this conformance period. In addition, banking entities with stand-alone proprietary trading operations are expected to promptly terminate or divest those operations. The Board of Governors of the Federal Reserve (the “Board”) may grant an extension of the conformance period for up to two additional one-year periods (either generally or on a case-by-case basis for individual banking entities) if, in the judgment of the Board, an extension is consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest. The Board may also grant a banking entity one additional extension for up to five years, to the extent necessary for the banking entity to fulfill a contractual obligation in effect on May 1, 2010 to provide additional capital to an illiquid fund.

The Volcker Rule consists of two key restrictions. First, banking entities are prohibited from engaging in proprietary trading (the “Proprietary Trading Provisions”). Second, banking entities are prohibited from sponsoring or investing in specified “covered funds” such as private equity or hedge funds, or extending credit to or engaging in other covered transactions with affiliated covered funds (the “Covered Fund Provisions”).² The Proprietary Trading Provisions are covered in Subpart B of the final regulations, and the Covered Fund Provisions are covered in Subpart C of the final regulations. Compliance program requirements are covered in Subpart D of the final regulations. This client advisory outlines the Proprietary Trading Provisions.

PROHIBITION ON PROPRIETARY TRADING

Under the Proprietary Trading Provisions, banking entities and their affiliates are broadly prohibited from engaging in proprietary trading, the definition of which is intended to capture the purchase or

¹ A copy of the final rule is available on the Federal Reserve website at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a1.pdf>. It was accompanied by a joint release (the “Release”) issued by the Agencies which provides useful discussion of the rule, comments received by the Agencies, and their reasons for making certain changes or additions to the proposed form of the rule first issued on October 11, 2011. For an overview of the Volcker Rule, please see our previous client advisories [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 our client advisory, [Volcker Rule: Final Regulations – Covered Fund Provisions](#) (December 18, 2013).

sale, as principal, of financial instruments for the purpose of short-term resale, benefitting from short-term price movements or realizing short-term arbitrage profits. The Proprietary Trading Provisions provide certain exemptions from the broad prohibition against proprietary trading, including for: underwriting securities, market-making activities, risk-mitigating hedging, repurchase and reverse repurchase agreements, securities lending transactions, liquidity management activities, trading in government obligations, transactions by foreign banking entities occurring outside the U.S., trading on behalf of customers, and clearance and settlement activities of clearing organizations and their members.

The broad prohibition against proprietary trading and the various exemptions to it are each the subject of complex definitional and substantive provisions. In addition, the rules mandate extensive internal compliance programs and the adoption of detailed policies and procedures at the individual trading desk level. Finally, larger banking entities will be obligated under the rules to capture and calculate transaction and position data on a variety of quantitative metrics on a daily basis and to report such data to regulators.

■ ***What activities are prohibited under the Proprietary Trading Provisions?***

- “Banking entities” are prohibited from engaging in “proprietary trading”, subject to certain exemptions described below.

■ ***What is a “banking entity”?***

- “Banking entity” includes (i) insured depository institutions, (ii) companies that control insured depository institutions, (iii) companies that are treated as bank holding companies for purposes of section 8 of the International Banking Act of 1978, and (iv) any affiliate or subsidiary of an entity described in (i) through (iii).
- “Banking entity” does not include the following entities, so long as any such entity is not itself a banking entity described in (i) through (iii) above:
 - a “covered fund”;
 - a portfolio company held under a banking entity’s authority to engage in merchant banking or insurance company investment activity under Section 4(k)(4)(H) or (I) of the Bank Holding Company Act of 1956 (the “BHC Act”); or
 - a portfolio concern controlled by a small business investment company under Section 103(3) of the Small Business Investment Act of 1958.
- “Banking entity” also does not include the FDIC, acting in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Act.

■ ***How is “proprietary trading” defined?***

- The term “proprietary trading” means engaging as principal for the “trading account” of the banking entity in any purchase or sale of one or more “financial instruments.”
 - A “financial instrument” is (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 (i) a loan, (ii) a commodity that is not an excluded commodity as defined under the Commodity Exchange Act (other than foreign exchange or currency), 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 delivery³, or (iii) foreign exchange or currency.
- A “trading account” is any account that is used by a banking entity to (i) purchase or sell one or more financial instruments principally 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 foregoing; (ii) purchase or sell 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 thereof, 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, (iii) purchase or sell one or more financial instruments for any purpose, if the banking entity is (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 that the financial instrument is purchased or sold in connection with the activities requiring such license or registration, or (iv) purchase or sell one or more financial instruments for any purpose, if the banking entity is 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.
 - *Rebuttable Presumption.* The purchase or sale of a financial instrument by a banking entity is presumed to be for the trading account of such entity if it holds the instrument for fewer than 60 days (or substantially transfers the risk of the financial instrument within 60 days of its purchase or sale), unless it can demonstrate that it did not purchase or sell the financial instrument principally for any of the prohibited purposes set forth in the definition of “trading account” above.
 - *Note:* There is no safe harbor, or reverse presumption, with respect to instruments held for 60 days or longer.⁴ Rather, the Agencies stated in the adopting release that they would evaluate all the facts and circumstances in determining whether particular trading activities constitute proprietary trading.⁵ Nonetheless, they also indicated that the presumption with respect to instruments held for fewer than 60 days was intended primarily to provide guidance to banking entities that are not subject to the market risk capital rules or are not covered securities or swap dealers and “accordingly may not have experience evaluating short-term trading intent.”⁶ The Agencies further stated that both the market risk capital and dealer prongs of the trading account definition were designed to capture trading with short-term intent, noting that (i) trading positions subject to the market risk capital rules are defined as those held for short-term purposes⁷, and (ii) “financial instruments purchased or sold by registered dealers in connection with their dealer activity are generally held with short-term intent,” and activities for which banking entities require a dealer’s license are “not necessarily all of the activities” of such entities.⁸
 - *Exclusions from Proprietary Trading.* Proprietary trading does not include:

³ For example, the spot purchase of a commodity would be excluded from the definition of “financial instrument,” but the acquisition of a futures position in the same commodity would not be. Release at p. 54.

⁴ Release at pp. 46-47.

⁵ Release at p. 47.

⁶ Release at p. 44.

⁷ Release at p. 40.

⁸ Release at pp. 41-42.

- *Repos.* Any purchase or sale of one or more financial instruments by a banking entity 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;
- *Securities Lending Transactions.* Any purchase or sale of one or more financial instruments by a banking entity 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 interest of an owner of such security, and has the right to terminate the transaction and to recall the loaned security;
- *Liquidity Management Transactions.* Any purchase or sale of a security by a banking entity for the purpose of liquidity management in accordance with a documented liquidity management plan that (i) specifically contemplates and authorizes the particular securities to be used for liquidity management purposes (outlining the amounts, types, and risks of these securities that are consistent with liquidity management), (ii) requires that such purchase or sale is principally for the purpose of managing liquidity, (iii) requires that such securities are highly liquid and not reasonably expected to result in appreciable profits or losses as a result of short-term price movements, (iv) limits such purchase or sale to an amount that is consistent with the banking entity's near-term funding needs, (v) includes written policies, procedures, internal controls, analysis and independent testing to ensure compliance with the regulations, and (vi) is consistent with the supervisory requirements, guidance and expectations related to liquidity management of any applicable overseeing federal agency;
 - *Note:* The Agencies in adopting this exclusion expressly declined to expand it to cover broader asset-liability management, earnings management, or scenario hedging activities.⁹
- *Clearing Organization Transactions.* Any purchase or sale of one or more financial instruments by a banking entity that is a derivatives clearing organization or a clearing agency in connection with clearing financial instruments;
- *Clearing Activities by Clearing Organization Members.* Any "excluded clearing activities" by 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;
 - "Excluded clearing activities" means any purchase or sale (i) to correct trading errors made by or on behalf of a customer that is cleared on a derivatives clearing organization, clearing agency, or designated financial market utility, (ii) in connection with and related to the management of a default or threatened imminent default of a customer or a member of a clearing agency, derivatives clearing organization, or designated financial market utility, or a default or threatened default of such a clearing agency, derivatives clearing organization, or designated financial market utility; or (iv) that is required by the rules or procedures of a clearing agency, derivatives clearing organization, or designated financial market utility to mitigate the risk to such entity resulting from the clearing by a member of security-based swaps that reference the member or an affiliate of the member.

⁹ Release at p. 66.

- *Delivery Obligations.* Any purchase or sale of one or more financial instruments by a banking entity, so long as such 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;
- *Judicial and Similar Proceedings.* Any purchase or sale of one or more financial instruments by a banking entity, so long as such purchase or sale satisfies an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization, or arbitration proceeding;
- *As Agent, Broker, or Custodian.* Any purchase or sale of one or more financial instruments by a banking entity that is acting solely as agent, broker, or custodian;
- *Compensation Plans.* Any purchase or sale of one or more financial instruments by a banking entity through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity, if the purchase or sale is made by the banking entity as a trustee for the benefit of employees of the banking entity; or
- *Debt Collections.* Any purchase or sale of one or more financial instruments by a banking entity 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 retains such instrument for longer than such period permitted by the applicable federal agency.
 - *Note:* This exclusion permits banking entities to take possession of margined collateral upon a customer default on a margin loan or failure to meet a margin call, provided it is divested as soon as practicable.¹⁰

EXEMPTIONS FROM PROHIBITIONS ON PROPRIETARY TRADING

The final 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. Importantly, these exemptions define the permitted activities and impose compliance and recordkeeping requirements at the level of the individual trading desk at which such activity is undertaken. “Trading desk” is 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.

■ *What activities are exempted from the prohibition on proprietary trading?*

- *Underwriting Activities.* The prohibition on proprietary trading does not apply to the purchase or sale of a financial instrument by a banking entity that is made in connection with the banking entity’s underwriting activities. Underwriting activities are permitted only if:
 1. The banking entity is acting as an underwriter¹¹ for a distribution¹² of securities and the trading desk’s underwriting position is related to such distribution;

¹⁰ Release at p. 79.

¹¹ 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.

¹² The term “distribution” means an offering of securities, whether or not subject to registration, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods, or an offering of securities made pursuant to an effective registration statement under the Securities Act of 1933.

2. The amount and type of the securities in the trading desk's underwriting position are designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties;
 3. 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;
 4. The banking entity has established an internal compliance program designed to ensure compliance with the regulations, including detailed policies and procedures at the individual trading desk level (see discussion below);
 5. The compensation arrangements of persons performing underwriting activities are designed not to reward or incentivize prohibited proprietary trading; and
 6. The banking entity is licensed or registered to engage in such underwriting activities in accordance with applicable law.
- *Note:* The underwriting exemption is intended to accommodate differences in the liquidity of markets and types of underwritten transactions applicable to various types of securities. While the rule requires a trading desk's underwriting position not to exceed the reasonable near term demand of clients, customers, and counterparties (not including the issuer's desire to sell the securities), the Agencies confirmed that an underwriter is not required to engage in book-building or other marketing efforts to determine investor demand, and the time it takes to complete a distribution may differ depending on liquidity, maturity, and the depth of the market. The Agencies also confirmed that "holding an unsold allotment when market conditions may make it impracticable to sell the entire allotment at a reasonable price at the time of the distribution and selling such position when it is reasonable to do so" is permitted. Additionally, the Agencies noted that activities conducted in connection with underwriting, such as stabilization, syndicate shorting, aftermarket short covering, and entering into call-spread options with issuers as part of convertible debt offerings are permitted under the exemption.¹³ However, it is important to bear in mind that long or short positions created in connection with an underwritten distribution are all deemed part of the "underwriting position" and therefore must be reduced within a reasonable time, and each trading desk is expected to operate under "robust limits on, among other things, the amount, types, and risks of its underwriting position and the period of time a security may be held."¹⁴ Note that the "trading desk" for these purposes may be a syndicate or underwriting desk, and it may manage an underwriting position that includes positions held at different affiliated legal entities and personnel in different locations.¹⁵
 - *Market Making-Related Activities.* The prohibition on proprietary trading does not apply to the purchase or sale of a financial instrument by a banking entity that is made in connection with the banking entity's market making-related activities. Market making-related activities are permitted only if:
 1. The trading desk that establishes and manages the financial exposure routinely stands ready to purchase or sell one or more types of financial instruments related to its financial exposure and is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles on a basis

¹³ Release at p. 112.

¹⁴ Release at p. 113.

¹⁵ Release at p. 103.

- appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments;
2. The amounts, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties;¹⁶
 3. The entity has established an internal compliance program designed to ensure compliance with the regulations, including detailed policies and procedures on an individual trading desk level (see discussion below);
 4. To the extent that any limit established for the trading desk in relation to its market-making activities is exceeded, the trading desk takes action to bring itself into compliance as promptly as possible;
 5. The compensation arrangements of persons performing market making-related activities are designed not to reward or incentivize proprietary trading; and
 6. The banking entity is licensed or registered to engage in such market-making activities in accordance with applicable law.
- *Risk-Mitigating Hedging Activities.* The prohibition on proprietary trading does not apply to the purchase or sale of financial instruments by a banking entity in risk-mitigating hedging transactions that are in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity and designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings. These risk-mitigating hedging activities are permitted only if:
 1. The entity has established an internal compliance program designed to ensure compliance with the regulations, including detailed policies and procedures on an individual trading desk level (see discussion below); and
 2. The risk-mitigating hedging activity (i) is in accordance with the written policies, procedures, and internal controls, (ii) at the inception of the hedging activity, including any adjustments, is designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks,¹⁷ arising in connection with and related to identified positions, contracts, or other holdings of the banking entity, (iii) does not give rise at the inception of the hedge to any significant new or additional risk that is not itself hedged contemporaneously, (iv) is subject to continuing review, monitoring, and management by the banking entity, including ongoing recalibration of the hedging activity, and (v) the compensation arrangements of persons performing the risk-mitigating hedging activities are designed not to reward or incentivize proprietary trading.
 - *Note regarding hedging strategies:* In their adopting release, the Agencies confirmed that certain hedging strategies such as dynamic hedging and anticipatory hedging are permitted if they otherwise comply with the requirements described above.¹⁸ However, the Agencies noted that the broadest forms of what is often referred to as “portfolio hedging” would not meet these requirements. Importantly, the rule does

¹⁶ Near term demand is required to be assessed on the basis of (i) the liquidity, maturity, and depth of the market for the relevant types of financial instruments and (ii) demonstrable analysis of historical customer demand, current inventory, market and other factors regarding the amount, types, and risks, of or associated with financial instruments in which the trading desk makes a market, including block trades.

¹⁷ Including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or similar risks.

¹⁸ Release at pp. 351-355.

permit the hedging of aggregated positions; however, the hedging activity must be related to, and mitigate, identifiable risks of specific, identifiable positions, contracts, or other holdings. More generalized risks faced by trading desks or the banking entity as a whole based on non-position-specific modeling or general risks to revenues or profits from market movements or economic conditions are not covered by the risk-mitigating hedging exemption.¹⁹

- *Note regarding hedging across trading desks and entities:* Additional documentation is required for any risk-mitigating hedging that is (i) not established by the specific trading desk establishing the underlying positions being hedged, (ii) established by the specific trading desk that is establishing the underlying positions but that is effected through a financial instrument, exposure, technique, or strategy that is not specifically identified in the trading desk's written policies and procedures, or (iii) established to hedge aggregate positions across two or more trading desks. The additional documentation must record the specific, identifiable risk(s) of the identified positions being hedged, the specific risk-mitigating strategy being used, and the trading desk or other business unit that is establishing and responsible for the hedge.
- *Other Exempted Trading Activities.*
 - *Domestic Government Obligations.* The prohibition does not apply to the purchase or sale by a banking entity of a financial instrument that is an obligation, participation, or other instrument of, or issued or guaranteed by, the United States, 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; an obligation of any state or political subdivision thereof, including any municipal security; or an obligation of the FDIC for the purpose of facilitating the disposal of assets acquired or held by the FDIC in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Act.
 - *Note:* Proprietary trading in derivatives on U.S. government and agency obligations, such as Treasury futures, is not permitted, unless otherwise in compliance with the market making or risk-mitigating hedging exemptions. In the adopting release, the Agencies note the role of primary dealers in the U.S. Treasury market and confirm that they may treat the U.S. government as a client, customer, or counterparty for purposes of the market-making exemption.²⁰
 - *Foreign Government Obligations.* The prohibition does not apply to:
 - *Foreign Banking Entities Trading in Home Country Obligations.* The purchase or sale by a banking entity of a financial instrument that is an obligation of, or issued or guaranteed by, a foreign sovereign (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision thereof, so long as (i) the banking entity is organized under, or directly or indirectly controlled by a banking entity organized under, the laws of such foreign sovereign, (ii) the banking entity is not controlled by a top-tier banking entity organized under U.S. laws, and (iii) the purchase or sale as principal is not made by an insured depository institution; and
 - *Foreign Subsidiaries of U.S. Banks Trading in Host Country Obligations.* The purchase or sale by a foreign entity that is owned or controlled by a U.S. banking

¹⁹ Release at p. 346.

²⁰ Release at pp. 364-367.

entity of a financial instrument that is an obligation of, or issued or guaranteed by, a foreign sovereign (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision thereof, so long as (i) the foreign entity is a foreign bank as defined by the Board in Regulation K, or is regulated by the foreign sovereign as a securities dealer, (ii) the financial instrument is an obligation of, or issued or guaranteed by, the foreign sovereign under which the foreign entity is organized (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision thereof, and (iii) the financial instrument is owned by the foreign entity and is not financed by an affiliate that is located in the United States or organized under U.S. laws.

- *Transactions on Behalf of Customers.* The prohibition does not apply to the purchase or sale of a financial instrument by a banking entity on behalf of a customer if (i) the banking entity is acting as trustee or in a similar fiduciary capacity for the customer, the transaction is for the account of or on behalf of the customer, and the banking entity does not have or retain beneficial ownership of the financial instrument; or (ii) the banking entity is acting as riskless principal in a transaction in which the banking entity, after receiving an order to purchase or sell a financial instrument from a customer, purchases or sells the financial instrument for its own account to offset a contemporaneous sale to or purchase from the customer.
- *Regulated Insurance Companies.* The prohibition does not apply to the purchase or sale of a financial instrument by an insurance company or any affiliate of an insurance company if (i) the insurance company or its affiliate purchases or sells the financial instrument solely for the general account of the insurance company or a separate account established by the insurance company, and (ii) 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.
- *Trading Activities of Foreign Banking Entities.* The prohibition does not apply to the purchase or sale of a financial instrument by a banking entity if (i) the banking entity is not organized, or directly or indirectly controlled by a banking entity that is organized, under U.S. laws, (ii) the purchase or sale is conducted pursuant to paragraph 9 or 13 of section 4(c) of the BHC Act,²¹ and (iii) the purchase or sale is conducted in accordance with the following additional requirements:
 1. The banking entity engaging as principal in the purchase or sale (including any personnel of the banking entity or its affiliates that arrange, negotiate, or execute the purchase or sale) is not located in the United States or organized under U.S. laws;
 2. The banking entity (including relevant personnel) that makes the decision to purchase or sell as principal is not located in the United States or organized under U.S. laws;

²¹ A purchase or sale is deemed to be conducted pursuant to paragraph (9) or (13) if (i) with respect to a banking entity that is a foreign banking organization, the banking entity meets the qualifying foreign banking organization requirements of Section 211.23(a), (c) or (e) of the Board's Regulation K, or (ii) with respect to a banking entity that is not a foreign banking organization, the banking entity meets at least two of the following requirements on a fully-consolidated basis: (1) the banking entity's total assets held outside of the United States exceed the total assets held in the United States; (2) total revenues from the banking entity's business outside of the United States exceed total revenues from the banking entity's business within the United States; or (3) total net income from the banking entity's business outside of the United States exceeds total net income from the banking entity's business within the United States.

3. The purchase or sale, including any transaction arising from risk-mitigating hedging related to the instruments purchased or sold, 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 U.S. laws;
4. 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 U.S. laws; and
5. The purchase or sale is not conducted with or through any U.S. entity²² other than (i) a purchase or sale with the foreign operations of a U.S. entity if no personnel of such entity located in the United States are involved in the arrangement, negotiation, or execution of such purchase or sale; (ii) a purchase or sale with an unaffiliated market intermediary²³ acting as principal, provided the purchase or sale is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty; or (iii) 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 cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty.

■ ***What overarching limitations apply to the exemptions outlined above?***

- The activities exempted from the prohibition on proprietary trading outlined above are nonetheless subject to three broad limitations:
 - ***Material Conflicts of Interest.*** No transaction or activity is permissible if it would involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties.
 - A “material conflict of interest” exists if the banking entity engages in any transaction, class of transactions, or 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 transaction, class or transactions, or activity, unless the banking entity (1) prior to engaging therein, makes a clear, timely, and effective disclosure of the conflict with sufficient information to permit the client, customer, or counterparty to meaningfully understand the conflict and provides it with the opportunity to negate, or substantially negate, any materially adverse effect created by the conflict, or (2) the banking entity establishes, maintains, and enforces information barriers that are reasonably designed to prevent the conflict from involving or resulting in a materially adverse effect on a client, customer, or counterparty.
 - ***Material Exposures to High-Risk Assets or Trading Strategies.*** No transaction or activity is permissible if it would result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy.
 - A “high-risk asset” means an asset or group of related assets that would, if held by the banking entity, significantly increase the likelihood that the banking entity would

²² A U.S. entity is any entity that is, or is controlled by, or acting on behalf of or at the direction of, any entity located in the United States or organized under U.S. laws. A U.S. branch, agency, or subsidiary of a foreign banking entity is considered to be located in the United States; however, the foreign bank that operates or controls it is not solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary.

²³ An “unaffiliated market intermediary” means an unaffiliated entity, acting as intermediary, that is a registered broker, swap dealer, security-based swap dealer, or futures commission merchant (or exempt or excluded from registering as such).

incur a substantial financial loss or pose a threat to the financial stability of the United States. A “high-risk trading strategy” is a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or pose a threat to the financial stability of the United States.

- *Threats to Safety and Soundness.* No transaction or activity is permissible if it would pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

COMPLIANCE PROGRAM REQUIREMENTS

Each banking entity is required to develop a program reasonably designed to ensure and monitor compliance with the prohibitions on proprietary trading activities and investments. The terms, scope, and detail of the compliance program must be appropriate for the types, size, scope, and complexity of activities and business structure of the entity.

■ *What internal compliance programs are required?*

- *Minimum Requirements.* The rules mandate an internal compliance program for banking entities with minimum requirements that include (i) written policies and procedures reasonably designed to document, describe, monitor, and limit trading activities subject to the final rules, (ii) a system of internal controls reasonably designed to monitor compliance with the rules and to prevent the occurrence of prohibited activities or investments, (iii) a management framework that clearly delineates responsibility and accountability for compliance, and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation, and other matters, (iv) independent testing and audit of the effectiveness of the compliance program conducted by qualified personnel of the banking entity or by a qualified outside party, (v) training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program, and (vi) making and keeping records sufficient to demonstrate compliance, which the banking entity must promptly provide to the appropriate federal agency upon request and retain for at least five years.
- *Written Policies and Procedures for Trading Desks.* The rules that permit underwriting, market-making, and risk-mitigating hedging activities specify that the banking entity establish, maintain, and enforce written policies and procedures specifically governing each of such activities, addressing the risks associated with it, and tailored for the individual trading desk undertaking it. The rules delineate elements that must be addressed in the policies and procedures related to each of such activities, such as the permitted types of securities and transactions that may be undertaken by a particular trading desk and position and risk limits that must be observed by it.
- *Enhanced Compliance Requirements for Certain Banking Entities.* Certain banking entities are subject to detailed “enhanced compliance program” requirements with respect to their proprietary trading activities, which are contained in Appendix B to the final regulations. In addition to the detailed Appendix B requirements addressing mechanical and other aspects of the compliance policies and procedures for specific activities, the Appendix also prescribes a governance and management framework as described below.
 - *Banking Entities Subject to Enhanced Compliance Requirements.* These banking entities generally include:
 - any banking entity (other than a foreign banking entity) that engages in permitted proprietary trading and that has, together with its affiliates and subsidiaries, 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 (on a worldwide consolidated basis) over the previous consecutive four quarters, equals or exceeds \$50 billion beginning on June 30, 2014, \$25 billion beginning on April 20, 2016, and \$10 billion beginning on December 31, 2016;

- any foreign banking entity that engages in permitted proprietary trading and whose combined U.S. operations (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) have trading assets and liabilities the average gross sum of which over the previous consecutive four quarters, equals or exceeds \$50 billion beginning on June 30, 2014, \$25 billion beginning on April 20, 2016, and \$10 billion beginning on December 31, 2016;
 - any banking entity (other than a foreign banking entity) that has reported total consolidated assets of \$50 billion or more;
 - any foreign banking entity that has total U.S. assets (including all subsidiaries, affiliates, branches, and agencies of the foreign banking entity operating, located, or organized in the United States) of \$50 billion or more; and
 - any banking entity that is notified by the appropriate federal agency in writing that it must satisfy such additional compliance requirements.
- *Governance and Management Framework.* Banking entities which are required to establish enhanced compliance programs must establish, maintain, and enforce a governance and management framework that is reasonably designed to ensure that appropriate personnel are responsible and accountable for the effective implementation and enforcement of the compliance program, a clear reporting line with a chain of responsibility is delineated, and the compliance program is reviewed periodically by senior management.
 - *Accountability for Business Line Managers.* Managers with responsibility for one or more trading desks of the banking entity are accountable for the effective implementation and enforcement of the compliance program with respect to the applicable trading desks.
 - *Accountability for Board of Directors and Senior Management.* The board of directors, or similar corporate body, and senior management are responsible for setting and communicating an appropriate culture of compliance with section 619 of the Dodd-Frank Act and the final regulations, and ensuring that appropriate policies regarding the management of trading activities and covered fund activities or investments are adopted to comply with section 619 of the Dodd-Frank Act and the final regulations. The final regulations also impose several specific new duties on the board of directors and senior management regarding the implementation and enforcement of the banking entity's enhanced compliance program.
 - *CEO Attestation.* Based on a review by the CEO of the banking entity, the CEO of the banking entity must annually attest in writing to the appropriate federal agency that the banking entity has in place processes to establish, maintain, enforce, review, test, and modify the banking entity's enhanced compliance program in a manner reasonably designed to achieve compliance with section 619 of the Dodd-Frank Act. 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 of the foreign banking entity who is located in the United States.

- *Banking Entities With Modest Activities.* A banking entity with total consolidated assets of \$10 billion or less, as reported on December 31 of the previous two calendar years, that engages in proprietary trading (other than permitted trading in U.S., State, or municipal government obligations and specified FDIC obligations) or sponsors or invests in covered funds may satisfy its compliance program requirements by including in its existing compliance policies and procedures appropriate references to the requirements in Section 619 of the Dodd-Frank Act and the final regulations, with adjustments as appropriate given the activities, size, scope, and complexity of the banking entity.
- *Banking Entities With No Covered Activities.* If a banking entity does not engage in proprietary trading (other than permitted trading in U.S., State, or municipal government obligations and specified FDIC obligations) or sponsor or invest in covered funds, the entity may satisfy the compliance program requirements by establishing the required compliance program prior to becoming engaged in such activities.
- ***What recordkeeping and reporting obligations are imposed?***
 - *Reporting and Recordkeeping.* A banking entity engaged in any proprietary trading activity permitted under the final regulations is required to comply with specific reporting and recordkeeping requirements (which are set forth in Appendix A of the final regulations) if:
 - the banking entity (other than a foreign banking entity) has, together with affiliates and subsidiaries, trading assets and liabilities (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or an agency thereof) the average gross sum of which (on a worldwide consolidated basis) over the previous consecutive four quarters, equals or exceeds \$50 billion beginning on June 30, 2014, \$25 billion beginning on April 20, 2016, and \$10 billion beginning on December 31, 2016;
 - in the case of a foreign banking entity, the combined U.S. operations (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) have trading assets and liabilities the average gross sum of which over the previous consecutive four quarters, equals or exceeds \$50 billion beginning on June 30, 2014, \$25 billion beginning on April 20, 2016, and \$10 billion beginning on December 31, 2016; or
 - the banking entity is notified by the appropriate federal agency in writing that it must satisfy such additional reporting requirements.²⁴
 - Banking entities with \$50 billion or more in trading assets and liabilities must report the information required for each calendar month within 30 days of the end of the relevant month; however, beginning with the information for the month of January 2015, such reports must be made within 10 days of the end of each calendar month. Other banking entities subject to the Appendix A reporting requirements will make their reports within 30 days of the end of the calendar quarter.

²⁴ Federal agencies may require other banking entities not meeting these tests to also comply with these recordkeeping and reporting obligations.

- Appendix A requires that the following quantitative measurements be calculated each day for the calculation periods indicated and included in reports made to the Agencies on the reporting schedule described above:

<i>Measurement</i>	<i>Description</i>	<i>Calculation Period</i>
Risk and Position Limits and Usage	The amount of risk that a trading desk is permitted to take at a point in time. Usage represents the portion of the trading desk's limits that are accounted for by the current activity of the desk.	One trading day
Risk Factor Sensitivities	Changes in a trading desk's comprehensive profit and loss that are expected to occur in the event of a change in one or more underlying variables that are significant sources of the trading desk's profitability and risk.	One trading day
Value-at-Risk	The commonly used percentile measurement of the risk of future financial loss in the value of a given set of aggregated positions over a specific period of time, based on current market conditions.	One trading day
Stress Value-at-Risk	The percentile measurement of the risk of future financial loss in the value of a given set of aggregated positions over a specified period of time, based on market conditions during a period of significant financial stress.	One trading day
Comprehensive Profit and Loss Attribution	Analysis that attributes daily fluctuation in the value of a trading desk's positions to various sources. These measurements must also calculate volatility of comprehensive profit and loss for the reporting period for at least a 30-, 60- and 90-day lag period, from the end of the reporting period.	One trading day
Inventory Turnover	A ratio that measures the turnover of a trading desk's inventory.	30, 60, and 90 days
Inventory Aging	A schedule of the trading desk's aggregate assets and liabilities and the amount of time that those assets and liabilities have been held.	One trading day
Customer-Facing Trade Ratio (Trade Count Based and Value Based)	A ratio comparing (i) the transactions involving a counterparty that is a customer of the trading desk to (ii) the transactions involving a counterparty that is not a customer of the trading desk. A trade count based ratio is calculated based on the number of transactions. A value based ratio is calculated based on the value of such transactions.	30, 60, and 90 days

If you would like to discuss the final regulations, please contact the following lawyers in our firm:

Frederick Knecht (co-author)	+1.212.841.1193	fknecht@cov.com
Warren Caywood (co-author)	+1.212.841.1069	wcaewood@cov.com
Carey Roberts (co-author)	+1.212.841.1034	croberts@cov.com
Bruce Bennett	+1.212.841.1060	bbennett@cov.com
John Dugan	+1.202.662.5051	jdugan@cov.com
Keith Noreika	+1.202.662.5497	knoreika@cov.com
Daniel Nazar (co-author)	+1.212.841.1091	dnazar@cov.com

This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

Covington & Burling LLP, an international law firm, provides corporate, litigation and regulatory expertise to enable clients to achieve their goals. This communication is intended to bring relevant developments to our clients and other interested colleagues. Please send an email to unsubscribe@cov.com if you do not wish to receive future emails or electronic alerts.

© 2013 Covington & Burling LLP, 1201 Pennsylvania Avenue, NW, Washington, DC 20004-2401. All rights reserved.