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Proprietary Trading Restrictions Under the Final Volcker Rule

Since the release of the proposed rule to implement the Volcker Rule (the Proposed Rule) more than two years ago, participants in the financial services industry have continued to express concern about the burden of complying with the proprietary trading restrictions in the Volcker Rule and the potential effects of those restrictions on the competitiveness of U.S. banks.[1] The final rule to implement the Volcker Rule (the Final Rule) was adopted by five U.S. financial regulators (the Agencies) on December 10, 2013. Institutions within the ambit of the Rule have only just begun to evaluate the Final Rule and the accompanying preamble (collectively, the Adopting Release) to ascertain the impact that the Rule will have on both their operations and the broader financial industry.[2]

Consistent with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) and the Proposed Rule, the Final Rule restricts the ability of banking entities to engage in proprietary trading, subject to the exceptions prescribed by statute. The exceptions are intended to allow banking entities to continue to provide traditional client-oriented financial services, including underwriting, market making-related and asset management services, and to continue hedging and liquidity management activities designed to enhance the safety of their operations.[3]

The full effect of the Final Rule and the practical implications of the differences between its proposed and final forms will be revealed only as the Agencies apply the Rule to the myriad financial transactions that will fall within its ambit over time. Even before all of its effects become evident, however, it appears clear that the heightened compliance program requirements contained in the Final Rule will require meaningful changes in many banking entities, the cost and effect of which may be tempered by the attempts the Agencies have made in the Final Rule to employ greater consistency across the proprietary trading exemptions and to develop a more nuanced approach to the realities of trading across differing markets and asset classes.

Prohibited Proprietary Trading

Consistent with the Dodd-Frank Act and the Proposed Rule, the Final Rule generally prohibits banking entities from engaging in "proprietary trading." Proprietary trading, as defined in the Final Rule, means "engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments."[4]

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[1] *See*, *e.g.*, Letter From Securities Industry and Financial Markets Association to Financial Stability Oversight Council 13 (Nov. 5, 2010), *available at* http://www.sifma.org/issues/item.aspx?id=22126; *Global Equity Research, J.P. Morgan Cazenove, Global Investment Banks — Regulatory Arbitrage Series: OW European Over US IBs* 22-32 (Mar. 8, 2011), *available at* http://www.scribd.com/doc/50801313/c (last visited Dec. 20, 2013).

[2] For up-to-date, detailed discussions on the Volcker Rule, please visit our website.

[3] *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (to be codified in various parts of 12 and 17 C.F.R.) [hereinafter Final Rule] §§ _.4-_.6 (Dec. 10, 2013) [the Final Rule together with the preamble accompanying its release hereinafter referred to as the Adopting Release], *available at* http://www.sec.gov/rules/final/2013/bhca-1.pdf.

[4] Final Rule § __.3(a).

Application of the Final Rule

The restrictions on proprietary trading set forth in the Volcker Rule apply to institutions that meet the criteria of "banking entities" as defined under the Final Rule, including:

- any insured depository institution,
- any company that controls an insured depository institution,
- any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978, and
- any affiliate[5] or subsidiary of any of the above.[6]

Excluded from the definition of "banking entity" are:

- any covered fund that is not itself a "banking entity" under the definition set out above;
- a portfolio company held under the authority contained in Section 4(k)(4)(H) or (I) of the Bank Holding Company Act of 1956 (the BHC Act), or any portfolio concern as defined under 13 C.F.R. § 107.50, that is controlled by a small business investment company, as defined in Section 103(3) of the Small Business Investment Act of 1958, so long as the portfolio company is not itself a "banking entity" under the definition set out above; and
- the Federal Deposit Insurance Corporation (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.[7]

Financial Instrument

The term "financial instrument" in the Final Rule replaces the term "covered financial position" in the Proposed Rule. This is largely a change in nomenclature, as the Final Rule effectively retains the substance of the proposal's term. Under the Final Rule, the term "financial instrument" includes:

- a security, including an option on a security;
- a derivative, including an option on a derivative; or
- a contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery.[8]

The term "financial instrument" does not include:

- a loan;[9]

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[5] Under the Final Rule, "affiliate" has the same meaning as in Section 2(k) of the BHC Act (12 U.S.C. § 1841(k)). Final Rule § __.2(a).

[6] Final Rule §§ __.2(c)(1)(i)-(iv).

[7] Final Rule §§ __.2(c)(2)(i)-(iii).

[8] Final Rule §§ __.2(c)(1)(i)-(iii).

[9] The Proposed Rule provided a limited definition of a "loan" but included no criteria for identifying a loan and did not indicate how equity-like control or economic futures in an instrument denominated as a loan would impact the determination as to whether the instrument would be viewed as a loan under the Rule. Despite seeking comments on how a loan should be defined, the Final Rule does not elucidate the definition contained in the Proposed Rule other than to clarify that no "security or derivative" will be considered a loan. Final Rule §__.2(s). For a further discussion of the treatment of "loans" under the Final Rule, *see also* "The Final Volcker Rule: Impact on Securitizations," *available at* http://www.skadden.com/sites/default/files/publications/Structured_Finance_Alert_The_Final_Volcker_Rule_Impact_on_Securitization.pdf.

- a commodity, other than an excluded commodity (as defined in the Commodity Exchange Act), a derivative, a contract of sale of a commodity for future delivery, or an option on such a contract; or
- foreign exchange or currency.[10]

Engaging as Principal for the Trading Account

Like the Proposed Rule, the Final Rule defines "trading account" as "any account that is used by a banking entity" as:

- a short-term trading account,
- a market risk capital account, or
- a dealer account.[11]

Each of these accounts is generally used for short-term trading activities. The Agencies took the view that the "trading account" definition did not require delineated exclusions, which are covered in the Final Rule under the exemptions for market making-related activities and the exclusions from proprietary trading.[12]

"Short-term trading accounts" include the accounts of banking entities used for the purchase or sale of one or more "financial instruments" principally for the purpose of:

- short-term resale,
- benefiting from actual or expected short-term price movements,
- realizing short-term arbitrage profits, or
- hedging one or more such positions.[13]

"Market risk capital accounts" include accounts that take positions classified as both covered positions and trading positions under the banking agency market risk capital rules, as well as hedges of those positions.[14] The inclusion of this prong of the definition advances the objective of achieving consistency between governance of the types of positions that a banking entity identifies as "trading" for the purpose of the market risk capital rules and those that are "trading" for the purpose of the Final Rule under Section 13 of the BHC Act.[15]

"Dealer accounts" include any account used by a banking entity to purchase or sell one or more financial instruments for any purpose, if the banking entity:

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

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[10] Final Rule §§ __.2(c)(2)(i)-(iii).
[11] Final Rule §§ __.3(b)(1).
[12] *See* Adopting Release at 38.
[13] Final Rule §§ __.3(b)(1)(i)(A)-(D).
[14] Final Rule §§ __.3(b)(1)(ii).
[15] *See* Adopting Release at 40.

- is engaged in the business of a dealer, swap dealer or security-based swap dealer outside the United States, to the extent the instrument is purchased or sold in connection with the activities of such business.[16]

Neither the Dodd-Frank Act nor the Final Rule expressly defines what constitutes a banking entity "engaging as principal" in a transaction.[17] The Adopting Release does, however, indicate that "the combination of references to engaging as principal and to a trading account [in the Volcker Rule] focuses on an entity's incurring risks of profit and loss through taking ownership of securities and other instruments."[18] Thus, the Agencies may be expected to inquire into whether a banking entity retains the risk of a transaction to determine whether, for the purposes of the Final Rule, it is engaging as principal in respect of that transaction.

Rebuttable Presumption

The Final Rule incorporates a rebuttable presumption that purchases or sales of a financial instrument are for a short-term trading account if held for fewer than 60 days.[19] The Final Rule also expands the presumption to cover the purchase or sale of any financial instrument (regardless of holding period) if the acquiring banking entity "substantially transfers" the risk of that financial instrument within 60 days of the purchase or sale.[20] The Adopting Release indicates that this expansion was intended to cover basis trades.[21]

The presumption of proprietary trading applies unless the banking entity can demonstrate, based on all relevant facts and circumstances, that it did not purchase or sell the financial instrument principally for the short-term purposes cited in the definition of short-term trading account. To reduce the costs and burdens of rebutting the presumption, the Agencies will allow banking entities to rebut the presumption for a group of related positions, however, the Final Rule does not provide any specific procedure for rebutting the presumption.[22]

Exclusions From Proprietary Trading

The Final Rule provides that "proprietary trading" excludes the following nine activities and transactions:

- any purchase or sale of one or more financial instruments by a banking entity that arises under repurchase or reverse repurchase agreements;
- any purchase or sale of one or more financial instruments by a banking entity that arises under securities lending agreements;
- any purchase or sale of a security by a banking entity for the purpose of liquidity management under a qualifying documented liquidity management plan to meet near term liquidity needs;
- any purchase or sale of one or more financial instruments by a banking entity that is a derivatives clearing organization or clearing agency (including certain foreign clearing organizations and entities);

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[16] Final Rule §§ __.3(b)(1)(iii)(A)-(B). The Agencies believe that the inclusion of dealer accounts in the definition of "trading account" is appropriate because instruments purchased or sold by registered dealers in connection with dealing activity are generally held with short-term intent. Adopting Release at 41.

[17] *See* Adopting Release at 419.

[18] Adopting Release at 419.

[19] Final Rule § __.3(b)(2). The Agencies refrained from tailoring the holding period to take into account variations in liquidity among the different types of instruments that are the subject of such trading activities. *See* Adopting Release at 46-47.

[20] *See* Final Rule § __.3(b)(2).

[21] *See* Adopting Release at 48.

[22] *See* Adopting Release at 47.

- any excluded clearing activity by a banking entity that is a member of a clearing entity, a member of a derivatives clearing organization or a member of a designated financial market utility;
- any purchase or sale of one or more financial instruments by a banking entity to:
  - satisfy an existing delivery obligation of the banking entity or its customer; or
  - satisfy an obligation in connection with a judicial, administrative, self-regulatory organization or arbitration proceeding;
- any purchase or sale of one or more financial instruments by a banking entity acting solely as agent, broker or custodian;
- any purchase or sale of one or more financial instruments by a banking entity through a deferred compensation or similar plan if the purchase or sale is made directly or indirectly by the banking entity as trustee for the benefit of persons who are or were employees of the banking entity; and
- any purchase or sale of one or more financial instruments by a banking entity in the ordinary course of collecting a debt previously contracted, provided the financial instrument is divested as soon as practicable.[23]

The Proposed Rule would have provided four exclusions from the definition of "trading account." The Final Rule excludes activities and transactions, independent of the trading account concept. The four exclusions provided by the Proposed Rule are largely replicated in the Final Rule, however, the Final Rule provides some meaningful modifications of those four exclusions. In particular, the Final Rule narrows the scope of the liquidity management exclusion to be available only for transactions in securities, rather than the broader range of financial instruments specified under the Proposed Rule. This change was intended to allow banking entities to rely on the liquidity management exclusion to use sufficient, readily marketable assets to meet needs for near term liquidity, but not to realize short-term profit or benefit from short-term fees.[24] As under the Proposed Rule, in an effort to prevent abuse of the liquidity management exclusion, the Final Rule requires banking entities to maintain a liquidity management plan that is consistent with the supervisory requirements, guidance and expectations regarding liquidity management of the agency responsible for regulating those entities.[25] The plan must, among other things, authorize the particular securities that may be used by an entity for liquidity management purposes, analyze the risks related thereto and describe the liquidity circumstances in which liquidity management activity with respect to such securities may, or must, be used. The Final Rule requires the liquidity management plan to address a range of liquidity management circumstances and to provide a mechanism through which these circumstances and the terms of the plan may be periodically reviewed by the responsible agency.[26] In addition, notwithstanding requests to expand the liquidity management exclusion in the Proposed Rule to include asset-liability management, earnings management or scenario hedging activity,[27] the Final Rule does not provide for any expansion in these areas.

Permitted Proprietary Trading Activities

In addition to the exclusions described above, the Final Rule permits banking entities to pursue the following permitted activities, as exceptions to the prohibition against proprietary trading:

[23] Final Rule §§ __.3(d)(1)-(9).
[24] *See* Adopting Release at 64.
[25] *See* Adopting Release at 64-65.
[26] Final Rule § __.3(d)(3).
[27] *See* Adopting Release at 61-64.

- underwriting and market making-related activities,[28]
- certain risk-mitigating activity,[29]
- trading on behalf of customers,[30]
- trading by a regulated insurance company and its affiliates for the general account of the insurance company,[31]
- trading in certain domestic and foreign government obligations (in order to support markets in those obligations),[32] and
- trading activities of foreign banking entities.[33]

We describe below these permitted activities, as set forth in the Final Rule.

Permitted Underwriting and Market Making-Related Activity

Consistent with both the Proposed Rule and the objective of allowing banking entities to continue to engage in traditional client-oriented financial services, the Final Rule permits certain underwriting and market making-related activities that would otherwise be treated as prohibited proprietary trading.

In line with the Proposed Rule, the Final Rule applies certain criteria to both the permitted underwriting and market making-related activities. The Agencies indicate that these overlapping criteria are intended to reduce the burden of compliance by creating consistency among permitted activities, as well as with existing applicable law and regulation.[34] First, in a departure from the Proposed Rule, which would have applied certain requirements of the underwriting and market making exemptions across the entire banking entity, the Final Rule applies the requirements of each of the exemptions at the "trading desk" level of the organization, which is defined as "the smallest discrete unit of organization of a banking entity that buys or sells financial instruments for the trading account of the banking entity or an affiliate thereof."[35] Second, to utilize either exception to the proprietary trading prohibition, a banking entity must establish an applicable internal compliance program that implements the requirements of the Final Rule.[36] Third, the compensation arrangements of persons who perform underwriting or market making-related activities must be designed not to reward or incentivize proprietary risk-taking.[37] Fourth, like the Proposed Rule, the Final Rule requires that permitted underwriting and market making-related activities correspond with the "reasonably expected near term demands of clients, customers, or counterparties."[38] Unlike the Proposed Rule, however, the Final Rule takes into account that the activities to be considered compliant with this requirement will necessarily vary based on the "liquidity, maturity, and depth of the market for the relevant types of financial instrument(s)" or asset class to which the market making-related and underwriting

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[28] Final Rule § __.4(a), § __ 4(b).
[29] Final Rule § __.5.
[30] Final Rule § __.6(c).
[31] Final Rule § __.6(d).
[32] Final Rule § __.6(a), § __ 6(b).
[33] Final Rule § __.6(e).
[34] *See* Adopting Release at 135.
[35] *See* Adopting Release at 192.
[36] *See* Adopting Release at 25.
[37] Final Rule §§ __.4(a)(2)(iv); §§ __.4(b)(2)(v).
[38] Final Rule § __.4(a)(2)(ii).

activities relate.[39] Reflecting the more nuanced approach contained in the Final Rule, the Adopting Release indicates that Agencies have expressed an understanding that the "near term demands" of a customer, client or counterparty in an illiquid or less mature market cannot be regarded in the same manner as in a highly liquid or mature market.[40]

Trading Desk Level

In a key modification of the Proposed Rule, which would have applied certain requirements of the underwriting and market making exemptions across an entire banking entity or to "other organizational units" of the entity, the Final Rule applies these requirements to the narrower trading desk level of the organization. Consistent with this approach, the compliance program requirements set out in the Final Rule, including the quantitative measurement reporting obligations, measure activities of each trading desk, rather than the banking entity as a whole.

The Agencies believe that establishing a defined organizational level at which to apply the underwriting and market making-related exemption requirements, as well as monitor compliance activity, will strengthen the effectiveness of and limit opportunities for evasion of the exemptions by ensuring that the aggregate trading activities of a discrete number of individuals in a single desk are conducted in a manner that is consistent with the standards of the exemptions.[41] In addition, the Agencies believe that applying the exemptions to the activities of a discrete and identifiable group of individuals whose responsibilities routinely relate to a specific type of transaction or financial instrument is consistent with broader refinements included in the Final Rule that aim to address and provide flexibility for the varying characteristics of the "financial instruments" to which the exemptions relate.[42]

Internal Compliance Procedures

In addition to the requirements of the Final Rule for compiling and reporting on the quantitative information (see "Compliance Requirements – Quantitative Measurements"), the Final Rule requires entities utilizing either the underwriting or market making-related exemptions to implement new internal compliance procedures.[43] Under the Final Rule, banking entities must establish internal compliance programs covering their underwriting and market making-related activities that specifically include reasonably designed written policies and procedures, internal controls, analysis and independent testing.[44]

The Final Rule provides a framework for the compliance procedures that is more detailed than the framework reflected in the Proposed Rule. The Final Rule requires that a compliance program with respect to a banking entity's underwriting activity must identify and monitor compliance with written policies and procedures for each of the following four elements, which must be tailored to the trading activities of each trading desk engaged in underwriting activities:

- the products, instruments or exposures that each trading desk may purchase, sell or manage as part of its underwriting activities, to facilitate monitoring and oversight of compliance with the exemption;[45]

[39] Final Rule §§ __.4(a)(2)(ii); §§ __.4(b)(2)(ii)(A).

[40] *See* Adopting Release at 253.

[41] *See* Adopting Release at 102-103.

[42] *See* Adopting Release at 103.

[43] The compliance program requirement is applicable to all banking entities that have total consolidated assets of more than $10 billion. Entities with less than $10 billion of total consolidated assets are permitted to address the compliance requirements of the Volcker Rule by adjusting their existing compliance programs in a manner that reflects the activities, scope, size and complexity of the applicable entity. Final Rule § __.20(f)(2). *See* Adopting Release at 25-27.

[44] *See* Final Rule § __.20(b).

[45] Final Rule § __.4(a)(2)(iii)(A).

- limits for each trading desk, based on the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers or counterparties,[46] that are designed to prevent a desk from systematically retaining unsold allotments even when there is sufficient customer demand;[47]
- internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits,[48] including the frequency, nature and extent of a desk exceeding its limits;[49] and
- authorization procedures, including escalation procedures that require review and approval of any trade that would exceed one or more of a trading desk's limits; demonstrable analysis of the basis for any temporary or permanent increase to one or more of a trading desk's limits; and independent review (*i.e.*, by risk managers and compliance officers at the appropriate level independent of the trading desk) of such demonstrable analysis and approval.[50]

The Final Rule also provides a more detailed framework for compliance programs of banking entities engaging in market making-related activity.[51] The Final Rule requires banking entities to identify and monitor compliance with written policies and procedures for the following items to ensure conformity with the market making-related exemption:

- the financial instruments that each trading desk stands ready to purchase and sell as a market maker in order to form the basis for specific types of inventory risk limits (which must be established for such entity);
- the actions that the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure consistent with the required limits; the products, instruments and exposures each trading desk may use for risk management purposes; the techniques and strategies each trading desk may use to manage the risks of its market making-related activities and inventory; and the process, strategies and personnel responsible for ensuring that the actions taken by the trading desk to mitigate these risks are and continue to be effective; and
- limits for each trading desk, based on the nature and amount of the trading desk's market making-related activities, that address the factors prescribed by the near term customer demand requirement of the Final Rule, on:
  - the amount, types and risks of its market-maker inventory;
  - the amount, types and risks of the products, instruments and exposures the trading desk uses for risk management purposes;
  - the level of exposure to relevant risk factors arising from its financial exposure; and
  - the period of time a "financial instrument" may be held;
- internal controls and ongoing monitoring and analysis of each trading desk's compliance with its required limits; and

[46] Final Rule § __.4(a)(2)(iii)(B). A trading desk must have limits on the amount, types, and risk of the securities in its underwriting position, level of exposures to relevant risk factors arising from its underwriting position, and period of time a security may be held. *See id.*

[47] Adopting Release at 122.

[48] Final Rule § __.4(a)(2)(iii)(C).

[49] Adopting Release at 277.

[50] Final Rule § __.4(a)(2)(iii)(D).

[51] The compliance program requirements for the underwriting and market making-related exemptions in the Final Rule are substantially similar, except that more detailed risk management procedures are required for market making activities due to the nature of the activity. The Agencies believe that the substantial overlap between the compliance requirements will reduce the burdens associated with developing and maintaining compliance programs for each trading desk. Adopting Release at 128.

- authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s); demonstrable analysis that the basis for any temporary or permanent increase to a trading desk's limit(s) is consistent with the requirements of § __.4(b)(2)(ii) of the Final Rule; and independent review (*i.e.*, by risk managers and compliance officers at the appropriate level independent of the trading desk) of such demonstrable analysis and approval.[52]

The inclusion of specific elements within the body of the Final Rule, rather than in an appendix,[53] is designed to highlight the importance of these compliance measures, as well as ensure that certain key features are included in a banking entity's compliance regime.

Pursuant to the Final Rule, each trading desk must establish appropriate limits with respect to the activities in which it engages, monitor such activities on an ongoing basis and provide for appropriate escalation procedures for activities exceeding established limits that incorporate external analysis and independent review. Although the Agencies recognize that this requirement may result in additional compliance costs to banking entities, they believe that monitoring at the level where the activity actually occurs is necessary to facilitate banking entity and agency monitoring and review of compliance activities.[54]

Compensation

The Final Rule substantially replicates the requirements included in the Proposed Rule surrounding compensation arrangements relating to both underwriting and market making-related activities. The Final Rule provides that the compensation of persons performing market making-related or underwriting activities on behalf of a banking entity cannot be designed to "reward or incentivize prohibited proprietary trading."[55] The Final Rule does not, however, preclude an employee from being compensated for market making-related or underwriting activity that may include some risk-taking. The objective of the Final Rule is to require a banking entity to provide incentives that primarily reward customer revenues and customer service rather than market price movements in the traded securities.[56]

Reasonably Expected Near Term Demands of Clients

The Final Rule retained the requirement in the Proposed Rule that underwriting positions or market-maker inventory be tied to the "reasonably expected near term demands of clients, customers, or counterparties."[57] In response to concerns about the potentially restrictive nature of this requirement and the costs of ongoing compliance with it,[58] however, the Rule has been refined to address the fact that the practical application of the "near term demand" requirement may vary based on the liquidity, maturity and depth of the market for the particular "financial instrument" to which the underwriting or market making-related activity relates.[59]

For the purposes of the underwriting exemption, the requirement will be satisfied if a trading desk has a reasonable expectation of demand from other market participants that warrants the amount and type of securities that it intends to acquire from an issuer or selling stockholder. A trading desk's "reasonable expectation" may derive from a number of factors, including current market conditions

[52] Final Rule § __.4(b)(2)(iii).

[53] The Proposed Rule generally included the elements from the Final Rule within the broader compliance requirements included in Appendix C to the Proposed Rule.

[54] Adopting Release at 199-200.

[55] Final Rule §§ __.4(a)(2)(iv) and 4(b)(2)(v).

[56] *See* Adopting Release at 289.

[57] Final Rule §§ __.4(a)(2)(ii);__.4(b)(2)(ii).

[58] *See* Adopting Release at 124-126.

[59] Final Rule §§ __.4(a)(2)(ii);__.4(b)(2)(ii)(A).

and prior experience with similar offerings of securities. The trading desk need not, however, engage in book building or similar marketing efforts to determine customer demand.[60] Moreover, the requirement would not necessarily prevent a trading desk from distributing an offering over a reasonable period of time in accordance with market conditions or retaining an unsold allotment of securities due to less-than-expected purchaser demand, provided that the desk had a reasonable expectation of buying interest and is engaged in reasonable selling efforts.[61] The desk must also make reasonable efforts to sell or otherwise reduce its underwriting position within a reasonable period, although the Agencies acknowledge that what constitutes a "reasonable period" may vary based on the liquidity, maturity and depth of the market for the relevant type of securities.[62]

The market making exemption additionally provides that the "near term demand" provision requires market-maker inventory to be based on a "[d]emonstrable analysis of historical customer demand, current inventory of financial instruments, and market and other factors regarding the amount, types, and risks, of or associated with financial instruments in which the trading desk makes a market."[63] A "demonstrable analysis" is an analysis based on factors that can be demonstrated in a manner that makes the analysis reviewable, which may include the trading records of the desk and readily available and retrievable market information.[64]

Revenue Requirements

In a notable departure from the Proposed Rule, the Final Rule has eliminated the requirement that revenues from underwriting and market making-related activities must be derived primarily from fees, commissions, underwriting spreads, bid/ask spreads or other income and not from appreciation in the value of the financial positions held by the banking entity or the hedging of related covered financial positions.[65] The Agencies state that this requirement was removed to address concerns that the Proposed Rule was not sufficiently nuanced to appropriately reflect revenue sources from underwriting activity or address unforeseen price movements and that the source-of-revenue limitation could adversely impact primary dealer activities.[66]

Permitted Underwriting Activity

In line with the Proposed Rule, the Final Rule permits a banking entity to engage in underwriting activities, even if such activities would otherwise be prohibited under the proprietary trading ban, provided the following conditions are satisfied:

- the banking entity acts as an "underwriter" in connection with a "distribution" of securities and the underwriting position relates to such distribution;[67]
- the amount and type of the underwritten position is designed to meet "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";[68] and

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[60] Adopting Release at 120-121.
[61] Adopting Release at 121-123.
[62] Adopting Release at 124.
[63] Final Rule § __.4(b)(2)(ii)(B).
[64] Adopting Release at 241.
[65] Final Rule § __.4(a)(2)(vi), § __.4(b)(2)(v).
[66] Adopting Release at 138.
[67] Final Rule §§ __.4(a)(2)(i), __.4(a)(3), __.4(a)(4).
[68] Final Rule § __.4(a)(2)(ii).

- the banking entity is licensed or registered to engage in the activity described in the underwriting exemption in accordance with applicable law.[69]

In addition, each banking entity, as discussed above, is required to implement and maintain a compliance program and to ensure that its compensation arrangements do not incentivize or reward prohibited proprietary trading.

The Final Rule is substantially consistent with the Proposed Rule with respect to the conditions applicable to the underwriting exclusion. The Final Rule, however, includes the following refinements, which, as the Agencies indicate, are designed primarily to "better capture the broad range of capital-raising activities facilitated by banking entities acting as underwriters on behalf of issuers and or selling security holders."[70]

First, as discussed above, the Final Rule provides that the trading desk is the organizational level at which the underwriting activities shall be assessed.

Second, the Final Rule broadens and clarifies the definition of "distribution," by removing the minimum offering size requirement and including an additional prong to the definition covering all offerings registered under the Securities Act of 1933. For the purposes of the underwriting exemption, therefore, "distribution" means:

- a registered or unregistered offering of securities distinguishable from ordinary trading transactions by the presence of special selling efforts or selling methods, or
- an offering of securities pursuant to an effective registration statement.[71]

The Agencies believe that the broadening of the definition, and particularly the inclusion of registered offerings as a definitive test, will reduce the administrative burden associated with determining whether a transaction qualifies as a distribution for the purposes of the underwriting exemption.[72]

Third, the Final Rule more closely aligns the definition of "underwriter" with the definition of a "distribution participant" in Regulation M under the Securities Exchange Act of 1934 (Regulation M) and refines the definition to clarify that members of both the underwriting syndicate and selling group may qualify as underwriters for the purposes of the exemption. The Final Rule clarifies that firms may fall within the definition even without a written agreement with the underwriter or underwriting syndicate to participate in the applicable distribution. As in the Proposed Rule, the Agencies in the Final Rule recognize that the activities of underwriters frequently vary. As such, the Adopting Release includes a number of factors that may be regarded as indicia of underwriting rather than as establishing a bright line test.[73]

Fourth, the Final Rule removed from the underwriting exemption the reference contained in the Proposed Rule to a purchase or sale being effected "solely" in connection with the distribution of securities. This change represents an effort to clarify that a banking entity may engage in ancillary

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[69] Final Rule § __.4(a)(2)(v).

[70] Adopting Release at 84.

[71] Final Rule § __.4(a)(3). Consistent with the Proposed Rule, the Final Rule relies on the same factors as Regulation M to analyze the presence of special selling efforts or methods. Indicia of special selling efforts and methods include delivering a sales document and conducting road shows.

[72] Adopting Release at 105.

[73] These factors comprise: assisting an issuer in capital raising; performing due diligence; advising the issuer on market conditions and/or assisting in the preparation of offering documents; purchasing securities from an issuer, selling security holder or underwriter for resale to the public; participating in or organizing a syndicate of investment banks; marketing securities; and providing a post-issuance secondary market and facilitating price discovery. Adopting Release at 109.

activities related to a particular distribution of securities when conducting its underwriting activities, including, among others, stabilization and after-market shorting activities, the retention of an unsold allotment of securities and the subsequent sale of any such unsold allotment. Such refinements, however, are not intended to suggest that any activity arguably connected to a distribution will fall within the underwriting exemption.[74] Accordingly, non-core activities, such as the purchase of another "financial instrument" to assist in determinations as to the pricing of securities that are the subject of a distribution, remain outside the scope of permitted underwriting activity.[75]

The Final Rule also attempts to clarify the circumstances under which an underwriter would be permitted to hold a residual position. A residual position may arise, for instance, in the context of an underwritten offering, including a bought deal, for which there is insufficient demand from a client, customer or counterparty at a reasonable price. The Final Rule does not, however, incorporate a bright line test to determine the presence of these circumstances. Instead, it provides that consideration should be given to "the liquidity, maturity, and depth of the market for the relevant type of security,"[76] when determining whether activity (including holding a residual position) is permitted under the underwriting exemption. This language may, in isolation, suggest that there may be circumstances where an underwriter may hold a residual position for an extended period to the extent that it is unable to exit such position at a reasonable price; however, this provision, read together with the requirement that a trading desk make "reasonable efforts … to sell or otherwise reduce [such a] position within a reasonable period,"[77] leads us to question whether an underwriter's ability to continue to hold such securities may be more limited and whether the Final Rule will allow the trading desk to hold the position indefinitely.

For example, an underwriter may engage in a block trade of securities that become unsellable at a reasonable price. Under these circumstances, the underwriter, issuer or selling stockholder may wish to cause the restricted period arising under Regulation M[78] to be terminated through the transfer by the underwriter of the unsold securities into an investment account for a period (often six months). The Final Rule, however, by requiring the underwriter to "make reasonable efforts to sell or otherwise reduce its underwriting position within a reasonable period," may preclude the underwriter, issuer or selling stockholder from taking any such action.[79]

Although the Final Rule does not define "reasonable efforts" or "reasonable period," given that securities may not be the subject of a continuous selling effort if a distribution is to be deemed complete and such securities are held and have come to rest in an investment account, taking the action to end the distribution period may fall outside the scope of the exemption in the Final Rule. As a result, in order to remain within the underwriting exemption, the underwriter engaging in the block trade described above would be prevented from placing the unsold securities into an investment account, causing the restricted period with respect to such securities to remain in effect (during which the trading restrictions imposed by Regulation M would continue to apply), potentially indefinitely. Any such result could deter issuers (typically established issuers who regularly employ bought deals as a means of financing) and selling stockholders from using bought deals as an efficient means of raising capital. The risks to regulated banking entities arising from the lack of clarity in this area may ultimately discourage banking entities from underwriting larger offerings as bought deals or motivate them to impose higher underwriting discounts in bought deals, which could increase the overall cost of raising capital.

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[74] Adopting Release at 113.

[75] Adopting Release at 113.

[76] Final Rule § __.4(a)(2)(ii).

[77] Final Rule § __.4(a)(2)(ii).

[78] 17 C.F.R. § 242.102(a)

[79] Final Rule § __.4(a)(2)(ii).

Permitted Market Making-Related Activity

Like the Proposed Rule, the Final Rule permits a banking entity to purchase or sell "financial instruments" in connection with the banking entity's market making-related activities.[80] The Final Rule, however, reflects a number of modifications to the Proposed Rule that are designed to address the fact that certain characteristics of market making-related activity vary across markets and asset classes. As noted above, the Final Rule also provides for examination of the "activities" conducted at the trading desk level of a banking entity to determine whether the market making exemption applies. The Agencies believe that a more flexible approach to the exemption is appropriate because the intermediation and liquidity services performed by a market maker will differ based on the liquidity, maturity and depth of the market for a given type of financial instrument.[81]

Market making-related activity is permitted under the Final Rule if:

- the trading desk that manages the "financial exposure" routinely stands ready to purchase and 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 appropriate for the liquidity, maturity and depth of the market for the relevant types of "financial instruments,"[82] and
- the amount, 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, based on:
  - the liquidity, maturity and depth of the market for the relevant types of "financial instrument(s)"; and
  - a demonstrable analysis of historical customer demand, current inventory of financial instruments, and 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 through block trades.[83]

As discussed above, the banking entity also is required to implement and maintain a compliance program with respect to its market making-related activity, specifically tailored to ensure conformity with the market making exception.[84] The compliance program must impose inventory and risk limits on each trading desk, and escalation procedures for any activity that exceeds such limits. Moreover, no trading desk may exceed risk limits purely on the basis of customer demand. Instead, the desk must first follow the escalation procedures established under the banking entity's compliance program (which may require additional approvals) and demonstrate that exceeding an established limit is consistent with the reasonably expected near term demand of its customers.[85]

Like the underwriting exemption, the market making exemption additionally requires that the banking entity ensure its compensation arrangements do not incentivize or reward prohibited proprietary trading.[86]

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[80] Final Rule § __.4(b)(1).
[81] Adopting Release at 140.
[82] Final Rule § __.4(b)(2)(i).
[83] Final Rule § __.4(b)(2)(ii)(B).
[84] Final Rule § __.4(b)(2)(iii).
[85] Adopting Release at 199-200.
[86] Final Rule § __.4(b)(2)(v).

'Financial Exposure' and 'Market-Maker Inventory'

The Agencies believe that an evaluation of the financial exposure and inventory of a trading desk will provide a guide as to whether the desk is engaging in permitted market making-related activity and promote compliance with the Rule's near term customer demand requirement.[87] Specifically, the market making restrictions in the Final Rule arise from the premise that an assessment of a trading desk's financial exposure will highlight the net exposure and risks associated with the desk's positions and, when evaluated in connection with risk mitigation and management activities employed by the desk in connection with such positions, will reveal the extent to which the trading desk is managing such risk in accordance with applicable limits.[88] An analysis of the amount, types and risks of the financial instruments in a trading desk's market-maker inventory is regarded as similarly important as it serves to identify the aggregate amount of such desk's inventory in financial instruments, the differing types of instruments for which such desk acts as a market maker and the risks arising out of such holdings.[89]

"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 desk, including the desk's open positions and exposures arising from open transactions.[90] In accordance with the Final Rule, the "financial instruments" that comprise such inventory must also be identified in the trading desk's compliance program and be disaggregated from the trading desk's other financial exposures for the purpose of establishing which financial instruments should be regarded as "market-maker inventory" to allow for better identification of the trading desk's hedging positions in instruments in which it does not make a market.[91] Although the Agencies recognize that this disaggregation requirement will impose additional costs on banking entities that do not already disaggregate the exposures of their trading desks, they nonetheless contend that disaggregation allows for better monitoring of whether a desk is engaging in permitted market making-related activity.[92] This monitoring objective is relevant to the provision of the Final Rule (see "Reasonably Expected Near Term Demands of Clients"), which prohibits the market-maker inventory of a trading desk from exceeding the reasonably expected near term demands of clients, customers or counterparties.

The Final Rule defines "financial exposure" 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 affiliate and managed by a particular trading desk as part of the trading desk's market making-related activities."[93] The Agencies have indicated that "financial exposure" is a broad concept which takes into account a trading desk's positions in "financial instruments" for which it does not act as a market maker but which are established as part of its market making-related activity, such as hedging or risk mitigation activity. Similarly, a trading desk's "financial exposure" may include positions that are booked in different affiliated legal entities. For such positions to be included in the trading desk's financial exposure for the purposes of permitted market making-related activities, however, the banking entity must maintain, and be able to produce promptly upon request, records that identify such positions.[94]

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[87] *See* Adopting Release at 198-199.
[88] *See* Adopting Release at 198.
[89] Adopting Release at 198.
[90] Final Rule § __.4(b)(5).
[91] Adopting Release at 198.
[92] Adopting Release at 199-200.
[93] Final Rule § __.4(b)(4).
[94] Adopting Release at 203-05.

Routinely Standing Ready to Buy and Sell

The market making exemption in the Proposed Rule had required a trading desk or other organizational unit of a banking entity to hold itself out as being willing to buy and sell (including through entering into long and short positions in) "financial instruments" for its own account on a regular and continuous basis.[95] In contrast, the Final Rule provides that a trading desk that manages a banking entity's financial exposure must "routinely stand ready" to purchase and sell one or more types of "financial instruments" related to its financial exposure.

The Agencies assert that this standard is more flexible than the standard included in the Proposed Rule, which was criticized during the comment period as being overly restrictive.[96] The Agencies recognize that the standard will vary to reflect that market making-related practices differ across markets and asset classes.[97] For example, market makers that trade in illiquid markets or assets may satisfy the requirement even if they trade only intermittently or in response to specific customer requests. Similarly, a trading desk attempting to engage in block positioning activity may meet the terms of the requirement provided that it carries out block trades from time to time.[98] Conversely, if a market maker were to trade intermittently or from time to time in highly liquid assets or markets, such activity would be unlikely to meet the standard required by the market making-related exemption.[99]

Although in the Final Rule the Agencies have embraced a more nuanced approach to the market making exemption, they continue to require a trading desk to exhibit a pattern of trading with customers or providing price indications on either side of the market irrespective of liquidity, maturity or depth of the market for a particular type of "financial instrument." Absent such pattern, a trading desk that creates customized instruments on an occasional basis is unlikely to satisfy the "routinely standing ready" requirement, even in a highly illiquid market.[100] As a result, trading desks may be deterred from dealing in customized or bespoke instruments. For certain types of issuers, this may decrease access to capital or make raising capital more costly.

The Agencies also emphasize, conversely, that a trading desk's routine presence in the market for a particular type of "financial instrument" is not, in itself, enough to bring the activity of such desk within the market marking-related exemption. The Final Rule states that a trading desk must also be engaged in activity that evidences a willingness of availability to quote, buy and sell (or otherwise enter into long and short positions in) the relevant type of "financial instrument" for its own account in commercially reasonable amounts throughout market cycles.[101] The Adopting Release notes that "commercially reasonable amounts" means that a trading desk must be willing to quote and trade in sizes requested by other market participants. This requirement extends throughout market cycles, not only when it is most favorable to do so.

Market Making-Related Hedging Activity

Just as in the Proposed Rule, market making-related hedging activities remain permissible under the Final Rule. If these hedging activities are conducted and directed by the trading desk that conducts the market making-related activity, the Final Rule requires only that the hedging activities satisfy

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[95] Proposed Rule § __.4(b)(2)(ii).

[96] *See* Adopting Release at 172.

[97] *See* Adopting Release at 187.

[98] Adopting Release at 208-09.

[99] *Cf.* Adopting Release at 207-209 (stating that market makers in liquid assets or markets "generally should engage in very regular or continuous quoting and trading activities on both sides of the market").

[100] Adopting Release at 208.

[101] Final Rule § __.4(7)(b)(2)(i).

the requirements of the trading desk's compliance manual for permitted market making-related activities.[102] This is a departure from the Proposed Rule, which would have required any market making-related hedging transactions to separately satisfy the requirements for general risk-mitigating permitted hedging activity. Consistent with the Proposed Rule, however, the Final Rule requires market making-related hedging activities conducted at a different level of organization from that of the trading desk conducting the market making activity to satisfy the requirements for the general risk-mitigating permitted hedging activity.[103] The Agencies explain that this revision is intended to provide banking entities with increased flexibility in determining how best to manage the risks of a trading desk's market making-related activities, while nonetheless addressing the Agencies' concern about increased risks of evasion that exist when risks being hedged are borne by a trading desk within a banking entity that is not the same as the desk or other unit of the banking entity that conducts the related hedging activities.[104]

Permitted Risk-Mitigating Hedging Activity

The Volcker Rule seeks to influence banking entities to structure their businesses in a manner that increases their safety and soundness. To this end, the Final Rule permits a banking entity to purchase or sell a "financial instrument" in connection with and related to individual or aggregated positions, contracts or other holdings of the banking entity and that is designed to reduce the specific risks to the banking entity in connection with such positions, contracts or other holdings.[105] As is the case for permitted underwriting and market making-related activities, banking entities seeking to engage in permitted risk-mitigating hedging activity must establish, implement, maintain and enforce an internal compliance program, including robust, detailed hedging policies and procedures designed to prevent prohibited proprietary trading in this context.[106]

Under the Final Rule, a banking entity's internal compliance program must specify, in writing, the positions or other holdings a trading desk may use in its risk-mitigating hedging activities, as well as position and aging limits for such positions or other holdings. In addition, the banking entity's compliance program must include procedures for ongoing monitoring, management and authorization, including escalation and approval procedures for hedging activities that would exceed the trading desk's authorization. Finally, the banking entity's compliance program must include procedures for analysis (including correlation analysis) and independent testing designed to ensure that the banking entity's positions, hedging techniques and strategies are reasonably expected to demonstrably reduce or significantly mitigate the specific, identifiable risks being hedged. Together, these new compliance provisions will effectively prohibit banking entities from engaging in certain types of generalized hedging activities. Furthermore, they will require banking entities to develop and implement a number of costly new policies and procedures merely to continue hedging specific and identifiable risks.

Risk-Mitigating Hedging Activity Requirements

If a banking entity wishes to engage in permitted risk-mitigating hedging activities, it will be required to establish that such activity:

- is conducted in accordance with the banking entity's written policies, procedures and internal controls established as described above;

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[102] Final Rule § __.4(b)(2)(iii)(B).

[103] Final Rule § __.4(b)(3)(ii).

[104] Adopting Release at 284.

[105] Final Rule § __.5(a).

[106] Final Rule § __.5(b)(1). *See also* Adopting Release at 329-33.

- is designed to reduce, or significantly mitigate, and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks arising in connection with and related to identified positions of the banking entity, based upon the facts and circumstances of the identified underlying and hedging positions or other holding and the risks and liquidity thereof;
- is reasonably correlated to risks intended to be hedged or mitigated;
- does not give rise, at the inception of the hedge, to significant exposures that were not already present in the hedged positions and that are not themselves hedged contemporaneously; and
- is subject to the banking entity's continuing review, monitoring and management that:
  - is consistent with the established hedging policies and procedures;
  - is designed to reduce or otherwise significantly mitigate the specific, identifiable risks that develop over time from the banking entity's permitted risk-mitigating hedging activities, based upon the circumstances of the underlying hedging positions and the risks and liquidity thereof; and
  - requires ongoing recalibration of hedging activity to ensure that the banking entity's hedging activity is not prohibited proprietary trading.[107]

In addition, the compensation arrangements of persons performing the risk-mitigating hedging activities must be designed not to reward proprietary risk-taking.[108]

The Final Rule also imposes a documentation requirement for certain of the banking entity's risk-mitigating hedging activities. Specifically, the documentation requirement is triggered any time a hedge is established at a different level of organization from that of the underlying risk or any time a trading desk hedges its own underlying risk using a "financial instrument," exposure or technique not specifically identified in the desk's written policies and procedures.[109] At the time of the purchase or sale of a risk-mitigating hedge requiring documentation, the banking entity must document the specific, identifiable risk(s) of the identified positions or other holdings that are the purpose of the respective hedge, the specific risk-mitigating strategy the purchase or sale is designed to fulfill, and the trading desk or other business unit that established and is responsible for the hedge.[110] Depending on the burden these new documentation requirements impose, certain banking entities may consider consolidating or reorganizing their trading desks, to the extent possible, to minimize future "cross-level" hedging activities.

General Characteristics of Permitted Hedging Activities

The Final Rule closely follows the statutory expression of the Volcker Rule[111] in allowing hedges of "individual or aggregated positions, contracts or other holdings," but adds a requirement that each such position be *identifiable*.[112] Under the Final Rule, permitted risk-mitigating hedging positions must be identifiable "with sufficient specificity so that at any point in time, the specific financial instrument positions or components of financial instrument positions held by the banking entity that comprise the set of positions being hedged can be clearly identified."[113] The Agencies explain that

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[107] Final Rule § __.5(b)(2)(i)-(iv).

[108] Final Rule § __.5(b)(3); *see also* Adopting Release at 357.

[109] Final Rule § __.5(c).

[110] Final Rule § __.5(c).

[111] Dodd-Frank Act § 619(d)(1)(C), 12 U.S.C. 1851(d)(1)(C).

[112] Adopting Release at 346-47.

[113] Adopting Release at 346.

this requirement is consistent with the statute because it reinforces that a banking entity is permitted to mitigate *specific* risk exposures rather than exposure across the entity on a macro basis.

Consistent with this rationale, portfolio hedging techniques are permissible under the Final Rule as long as a banking entity can specifically identify the risk factors for the aggregated set of positions that is being hedged.[114] Similarly, the Final Rule permits anticipatory hedging provided that the banking entity can specifically identify the anticipated risk being hedged.[115] The Agencies expect that the policies and procedures of a banking entity's trading desk will address circumstances under which anticipatory hedging is appropriate (though the Adopting Release offers no instruction in that regard). Also, if the anticipated risk does not materialize within a limited period after establishing the anticipatory hedge, the Agencies expect the trading desk to extinguish the hedge position or demonstrably reduce the risk associated with such position as soon as reasonably practicable.[116] Since the Final Rule requires a banking entity to engage in ongoing monitoring of its hedges to reduce or significantly mitigate the material changes in risk that develop in time, the Agencies also suggest that dynamic hedging, a hedging technique that requires continuous adjustment of the hedge position over time, is permitted (and in some circumstances may even be required).[117]

In contrast, if the risks being hedged are more generalized or not in connection with one or more specific, identifiable positions, the Final Rule generally would not permit a banking entity to rely on the exception for permitted risk-mitigating hedging activities. In the Adopting Release, the Agencies describe the types of generalized hedging that would not qualify for the exception as including hedging activity that is designed to:

> reduce risks associated with the banking entity's assets and/or liabilities generally, general market movements or broad economic conditions; profit in the case of a general economic downturn; counterbalance revenue declines generally; or otherwise arbitrage market imbalances unrelated to the risks resulting from the positions lawfully held by the banking entity.[118]

Additionally, the Adopting Release provides that hedging that introduces new or additional unhedged significant exposures at inception is indicative of proprietary trading and is prohibited unless such new or additional exposure are contemporaneously hedged.[119]

The treatment of correlation analysis in the Adopting Release is nuanced. Under the Final Rule, a banking entity must conduct correlation analyses with respect to its risk-mitigating hedging activities as a condition of such activities being exempted from the prohibition on proprietary trading.[120] Even though the Final Rule requires a banking entity to conduct correlation analyses, however, the Adopting Release provides expressly that evidence of negative correlation between a hedging position or strategy and a hedged risk is not an independently sufficient indicator that the position or strategy is a permissible risk-mitigating hedge.[121] The Agencies explain that even where negative correlation is demonstrated, a hedging position or strategy still must be "demonstrably risk reducing

[114] Adopting Release at 346.

[115] The Final Rule abandons the proposed requirement in the Proposed Rule that an anticipatory hedge be established only "slightly" in advance of the materialization of the anticipated risk. Adopting Release at 354.

[116] Adopting Release at 355.

[117] Adopting Release at 351.

[118] Adopting Release at 346.

[119] *See* Adopting Release at 341.

[120] Final Rule § __.5(b)(1)(iii).

[121] Conversely, the Agencies also recognize that positive correlation does not conclusively establish that a hedging position or strategy is impermissible proprietary trading. Adopting Release at 350.

or mitigating, rather than simply correlated to risk."[122] Conversely, if a negative correlation cannot be demonstrated, the position is not *per se* impermissible; rather, the Agencies will expect a banking entity to explain how the hedge reduces or mitigates risk without being negatively correlated.[123]

The Final Rule suggests that deviations from a banking entity's established hedging policies and procedures, without obtaining prior authorization in accordance with such policies and procedures, is a potential indication of proprietary trading.[124] This is reflected specifically in the documentation requirement for a hedge established at a different level of organization from the underlying exposure or a hedge involving a different "financial instrument," exposure or technique not specifically identified in the desk's written policies.[125] Consistent with the Proposed Rule, the documentation requirement derives from the Agencies' concern that the separation of the hedge and the underlying exposure at different levels of organization might otherwise present heightened potential for prohibited proprietary trading by allowing the banking entity to match trades after the fact to other risks that happened to exist at the time of the putative hedge.[126] Banking entities, however, may choose to move hedging activities to the level that generated the underlying risks to avoid this additional layer of documentation.

Permitted Trading in Domestic Government Obligations

The Final Rule substantially follows the approach of the Proposed Rule in exempting domestic government obligations and adds an exemption for obligations of the FDIC under certain circumstances.[127] The prohibition on proprietary trading does not apply to the purchase or sale by a banking entity of a "financial instrument" that is:

- an obligation of, or issued or guaranteed by, the United States;
- an obligation, participation or other instrument of, or issued or guaranteed by, an agency of the United States, the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. § 2001 *et seq.*);
- an obligation of any State or any political subdivision thereof, including any municipal security; or
- an obligation of the FDIC or any entity formed by or on behalf of the FDIC for 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.[128]

Permitted Trading in Foreign Government Obligations

Both the Proposed and Final Rule exempt trading in certain domestic government obligations (as described above) from the proprietary trading restrictions, but the Proposed Rule provided no exemption for any foreign government obligations.[129] The Final Rule adds two new exemptions for trading in foreign sovereign debt and related obligations. The Final Rule provides that:

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[122] Adopting Release at 349.
[123] Adopting Rele ase at 332.
[124] Adopting Release at 350.
[125] Final Rule § __.5(c).
[126] Adopting Release at 361.
[127] *See* Adopting Release at 364-68.
[128] Final Rule § __.6(a).
[129] Adopting Release at 368.

- the U.S. operations of non-U.S. banking entities may engage in proprietary trading in the U.S. in the obligations of the foreign sovereign under whose laws the non-U.S. banking entity is organized, the obligations of any of that country's agencies or political subdivisions, and the obligations of any multinational central bank of which the foreign sovereign is a member, so long as the trading is not done by an insured depository institution;[130] and
- non-U.S. banks and non-U.S. broker-dealers regulated as securities dealers controlled by a U.S. banking entity may engage in proprietary trading in the obligations of the foreign sovereign under whose laws they are organized, including agency and political subdivision obligations, as well as the obligations of any multinational central bank of which the foreign sovereign is a member.[131]

The Agencies implemented these "limited exemption[s]" in an effort "to continue to support the smooth functioning of markets in foreign sovereign obligations in the same manner as U.S. banking entities are permitted to support the smooth functioning of markets in U.S. government and agency obligations."[132] Additionally, the Adopting Release suggests that the exemption for the non-U.S. banks and broker-dealers controlled by U.S. banking entities was added to help such institutions remain competitive.[133]

Permitted Trading on Behalf of Customers

Like the Proposed Rule, the Final Rule permits trading on behalf of customers in which gains and losses flow to the customer and not the banking entity. Unlike the Proposed Rule, the Final Rule does not explicitly permit investment advisers or commodity trading advisors to trade on behalf of customers in Section __.6(c)(1) and instead limits the exception to fiduciary obligations generally. The Final Rule provides that the following categories of trading are permitted:

- trading in a fiduciary capacity where the transaction is conducted for the account of the customer and the banking entity does not have or retain beneficial ownership of the financial instrument,[134] and
- riskless principal transactions (in which the banking entity enters into a purchase or sale of a financial instrument for its own account to offset a contemporaneous sale to or purchase from a customer).[135]

In a refinement of the Proposed Rule aimed at better aligning the exemptions from proprietary trading, the Final Rule has moved the exemption for trading activity conducted by a banking entity that is a regulated insurance company for the separate account of insurance policyholders into the provision exempting trading activity in an insurance company's general account.

Overriding Restrictions on Permitted Activities

Consistent with the Proposed Rule, the Final Rule prohibits transactions or activities that would otherwise be permitted if such transactions or activities:

- involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties;

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[130] Final Rule § __.6(b)(1).

[131] Final Rule § __.6(b)(2).

[132] Adopting Release at 376.

[133] *See* Adopting Release at 377.

[134] Final Rule § __.6(c)(1).

[135] Final Rule § __.6(c)(2). Importantly, the Final Rule does not permit a banking entity to purchase (or sell) a financial instrument without first having a customer order with respect to such purchase or sale. Adopting Release at 397.

- result in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or
- pose a threat to the safety and soundness of the banking entity or U.S. financial stability.[136]

The Adopting Release indicates that the Agencies intend to develop additional guidance regarding best practices for addressing potential material conflicts of interest, high-risk assets and trading strategies and practices that pose significant risks to safety and soundness and to the U.S. financial system as they (and banking entities) gain experience with Section 13 of the BHC Act and Section __.7 of the Final Rule, which are all generally designed to limit risky behavior in trading and investment activities.[137]

The conflict of interest restriction in the Final Rule is substantially consistent with the restriction contained in the Proposed Rule. The Final Rule defines "material conflict of interest" to include any transaction or activity that would involve the banking entity's interest being materially adverse to the interest of its client, customer or counterparty. The Final Rule provides that a banking entity may address or substantially mitigate a potential conflict of interest by making adequate disclosures or creating or enforcing informational barriers.[138]

The disclosure standard requires that "clear and meaningful information" containing "reasonable detail" must be provided to the client, customer or counterparty in a timely fashion and in a manner that allows such party to substantially mitigate or negate the material adverse effects created by such conflict.[139] The Agencies do not, however, require that the conflict of interest be fully negated. Contrary to suggestions made by commenters to the Proposed Rule,[140] the Agencies do not believe a waiver or consent by a client, customer or counterparty will, in and of itself, be sufficient to satisfy the negation or mitigation requirement.

The management of conflicts of interest through informational barriers under the Final Rule requires that a banking entity establish, enforce and maintain informational barriers that are memorialized in written policies and procedures. The procedures must provide for the separation of personnel or banking functions in a manner reasonably designed to prevent the conflict from involving or resulting in a material adverse effect on a client, customer or counterparty.[141] The Final Rule provides, however, that, notwithstanding the establishment of informational barriers, a banking entity cannot rely on such barriers to address or mitigate the conflict if it knows, or reasonably should have known, that a material conflict arising out of a specific transaction, or class of transaction, may involve or result in a material adverse effect on the client, customer or counterparty.[142]

The Final Rule provides that "high-risk" assets and trading strategies are those that, if held or employed by a banking entity, would significantly increase the likelihood of the banking entity incurring a substantial financial loss or would pose a threat to the financial stability of the United States.[143] Banking entities may not pursue transactions or activities that result in material exposure to such high-risk assets or trading strategies, even if such transactions or activities would otherwise be permitted by the Final Rule.

[136] Final Rule §§__.7(a)(1)-(3).
[137] Adopting Release at 435.
[138] Final Rule §§__.7(b)(1)-(2).
[139] *See* Final Rule §§__.7(b)(2).
[140] *See* Adopting Release at 446.
[141] Final Rule §§__.7(b)(1)-(2).
[142] Adopting Release at 455-56.
[143] Final Rule §__.7(c).

Compliance Requirements — Quantitative Measurements

Like the Proposed Rule, the Final Rule imposes a number of compliance and procedural requirements on banking entities. In the Final Rule, the Agencies sought to tailor those requirements to the size and characteristics of different banking entities.[144] The Final Rule creates five categories of banking entities[145] based on size and level of involvement in activities covered by the Final Rule and applies increasingly stringent and comprehensive compliance requirements to banking entities in larger and more involved categories.

As a component of the compliance requirements, the Final Rule includes a series of quantitative measurements that must be reported by each banking entity engaged in "significant trading activity." Furthermore, although the Federal Reserve exercised its independent authority to grant to all banking entities a blanket one-year extension of the conformance period for the Final Rule, banking entities that have $50 billion or more in consolidated trading assets and liabilities will be required to comply with the quantitative measurement reporting requirements included in Appendix A of the Final Rule beginning on June 30, 2014.[146]

The measurements included in the Final Rule are designed to provide a means of characterizing the overall risk profile of the trading activities of each trading desk, while calculating whether the quantitative profile of such trading desk's activities is consistent with permissible trading activities in a cost efficient and effective manner. In response to concerns regarding the complexity and burden of compliance arising from the Proposed Rule, the Final Rule has significantly reduced the number of quantitative measurements.[147] Accordingly, the Final Rule contains seven, rather than 17, measurements, which are grouped into three, rather than five, broader categories. The categories and measurements comprise:[148]

- risk-management measurements, which provide a means through which to characterize the overall risk profile of the trading activities of each trading desk and evaluate the extent to which the quantitative profile of the desk's activities is consistent with permissible activities.[149] The risk management measurements include:
  - Risk and Position Limits and Usage,
  - Risk Factor Sensitivities, and
  - Value-at-Risk and Stress VaR.
- a source-of-revenue measurement, described as "Comprehensive Profit and Loss Attribution," which is designed to capture the extent, scope and type of profits and losses generated by trading activities and provide important context for understanding how revenue is generated by trading activities;[150] and

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[144] Final Rule § __.20(a).

[145] The five categories are: (i) banking entities that have $50 billion or more in consolidated trading assets and liabilities; (ii) banking entities that have at least $25 billion but less than $50 billion in consolidated trading assets and liabilities; (iii) banking entities that have at least $10 billion but less than $25 billion in consolidated trading assets and liabilities; (iv) banking entities that have $10 billion or less in consolidated trading assets and liabilities; and (v) banking entities that do not engage in covered activity. *See generally* Adopting Release at 23-26.

[146] Final Rule § __.20(d)(2).

[147] Adopting Release at 817-818.

[148] Final Rule — Appendix A(IV).

[149] Adopting Release at 834.

[150] Adopting Release at 841.

- customer-facing activity measurements, which aim to provide directionally useful information regarding the extent to which trading transactions are conducted with customers. The customer-facing activity measurements include:
  - Inventory Turnover,
  - Inventory Aging, and
  - Customer-Facing Trade Ratio.

Banking entities are required to calculate quantitative measurements on a daily basis and report each applicable measurement to the applicable supervisory agency on the schedule set out in Section __.20 of the Final Rule, which varies based on the size and characteristics of different banking entities. The largest banking entities, with $50 billion or more in total consolidated trading assets and liabilities, must report on a monthly basis, and must generally furnish such reports to the applicable supervisory agency no later than 10 days after the end of the month to which the measurements relate.[151]

Consistent with the other provisions of the Final Rule (including permitted underwriting and market making-related activities), the Final Rule mandates that the quantitative measurements be applied at the "trading desk" level. The Final Rule does not, however, impose specific numerical thresholds as a component of the quantitative measurement requirements, because such thresholds are considered to be counterproductive due to the range of "financial instruments" and trading activities contained in the Final Rule.[152]

Although the reduction in the number of quantitative measurements initially suggests that the compliance burden of the Final Rule may be less onerous than that included in the Proposed Rule, the fact that the measurements must be reported at the trading desk level limits the moderating impact of the approach adopted in the Final Rule. As a result, it is likely that the Final Rule will impose significant compliance costs on banking entities, particularly those with $50 billion or more in total consolidated trading assets and liabilities.

[151] Final Rule § __.20(d)(3).

[152] Adopting Release at 828.

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