FREQUENTLY ASKED QUESTIONS

ABOUT THE PROPRIETARY TRADING ASPECTS OF THE VOLCKER RULE

The Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission (the "*SEC*") issued a final rule, and the Commodity Futures Trading Commission (the "*CFTC*" and, collectively with the other regulatory agencies listed above, the "*Agencies*") issued a parallel final rule (together, the "*Final Rule*") on December 10, 2013, to implement the restrictions contained in Section 619 of the Dodd-Frank Act, commonly known as the "Volcker rule." The Volcker rule generally prohibits banking entities from engaging in proprietary trading and from sponsoring and/or investing in certain types of private funds (i.e., covered funds).

In this summary, we provide answers to certain frequently asked questions related to the proprietary trading aspects of the Volcker rule based upon the statutory language, the Final Rule, the regulatory history and the explanatory preamble that accompanied the issuance of the Final Rule (the "Preamble"). Goodwin Procter previously released a summary that addressed FAQs relating to the covered funds aspects of the Volcker rule.

Q-1: Who is subject to the Volcker rule?

All "banking entities" are subject to the Volcker rule. A "banking entity" is defined in Section 13(h)(1) of the Bank Holding Company Act of 1956, as amended (the "*BHC Act*") and Section __.2(c) of the Final Rule generally as:

- 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, as amended (the "*International Banking Act*"); and
- Any affiliate or subsidiary of the foregoing banking entities.[1]

As a result, the definition of "banking entity" covers most types of deposit taking institutions (including state banks, national banks, state and federally chartered savings associations, industrial banks, and credit card banks), bank holding companies, savings and loan holding companies, and companies that control limited purpose insured depository institutions such as credit card banks and industrial banks. The definition also includes foreign banks with a branch or agency office in the United States as well as any company that controls such a foreign bank. In contrast, credit unions and most limited purpose trust companies are not treated as insured depository institutions for purposes of the Volcker rule and, therefore, are not banking entities subject to the Volcker rule (unless they are within the definition for other reasons, such as being an affiliate or subsidiary of a banking entity).

As noted, the definition of "banking entity" also includes affiliates and subsidiaries of any of the types of entities described in the definition, which means that holding companies of banking entities and their non-bank subsidiaries and affiliates would fall within the definition of banking entity subject to the Volcker rule. However, the Final Rule contains an important exclusion from the definition of "banking entity" for:

- any covered fund,
- any portfolio company held by a financial holding company in reliance upon the merchant banking authority in Section 4(k)(4)(H) or Section 4(k)(4)(I) of the BHC Act, and

- any portfolio concern that is controlled by a small business investment company, provided that the covered fund, portfolio company or portfolio concern is not itself a banking entity by reason of being an insured depository institution, a company that controls an insured depository institution or a company treated as a bank holding company under Section 8 of the International Banking Act.[2]

As a result of this exclusion, these types of entities are not treated as banking entities subject to the ban on proprietary trading, notwithstanding their affiliation with a banking entity.

Also, while proprietary trading is not prohibited under the Volcker rule for nonbank companies that are designated by the Financial Stability Oversight Council under Section 113 of the Dodd-Frank Act as being subject to prudential supervision by the Federal Reserve Board ("Non-bank SIFIs"), the Agencies are required by statute to adopt rules imposing additional capital requirements and quantitative limitations on Non-bank SIFIs engaged in certain proprietary trading or covered funds activities subject to the Volcker rule.[3] The Final Rule does not specify any additional restrictions applicable to Non-bank SIFIs, but the Agencies noted that they are reviewing whether any such additional restrictions are necessary.

Q-2: What is proprietary trading?

With limited exceptions, the Volcker rule prohibits banking entities from engaging, as principal, in "proprietary trading". Section __.3(a) of the Final Rule defines "proprietary trading" as "engaging as principal for the *trading account* of the banking entity in any purchase or sale of one or more *financial instruments*." (Emphasis added.) See Question 3 for a discussion of trading accounts and Question 4 for a discussion of the types of financial instruments subject to the proprietary trading ban.

The definition of proprietary trading in the Final Rule is in substance the same as the statutory definition and the definition of proprietary trading set forth in the proposed Volcker Rule implementing regulation and discussed in *Goodwin Procter's Financial Services Alert of October 20, 2011*.[4] As established under the statute, there is a prohibition on any activity that constitutes "proprietary trading" but is not excluded from the definition or specifically subject to an exemption (see Q-4 through Q-11 for a discussion of various exemptions). Under the Final Rule, the definition of proprietary trading excludes the following types of transactions.

- ***Repurchase Agreements***. The definition of proprietary trading excludes a purchase or sale of financial instruments under a repurchase or reverse repurchase agreement meeting specified criteria.[5] In the Preamble, the Agencies explained that positions held under these types of agreements are in economic substance similar to a secured loan and are not based on actual or expected movements in prices.[6]

- ***Securities Lending and Borrowing***. Proprietary trading also excludes any purchase or sale of financial instruments pursuant to a written securities lending agreement meeting specified criteria.[7] Of course, other positions in the same security, such as short positions related to the loan, may not benefit from this exception and may involve proprietary trading,[8] and collateral investment pools may be subject to the aspects of the Final Rule relating to covered funds. (See Goodwin Procter's Financial Services Alert, "*Covered Funds Aspects of the Volcker Rule – Frequently Asked Questions*," December 17, 2013.)

- ***Liquidity Management***. There is an exclusion from the definition of proprietary trading for 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 of the banking entity that meets certain requirements described in the Final Rule.[9] In general, this exception only applies with respect to highly liquid securities and in circumstances where the banking entity does not expect the transaction to result in appreciable profits and losses as a result of short term price movements. Further, the exception is limited to liquidity management purposes and must be tailored so that it is consistent with the banking entity's near term funding needs.

- ***Clearing Activities***. The Final Rule provides that proprietary trading does not include (i) the 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,[10] or (ii) certain clearing activities conducted by a banking entity as a member of a clearing agency, derivatives clearing organization, or designated financial market utility.[11]

- ***Prevention of Failed Trades***. The Final Rule also adds an exemption for the purchase or sale of financial instruments if the transaction: (i) 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; or (ii) satisfies an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization, or arbitration proceeding.[12]

- ***Agency, Brokerage or Custodial Activities***. The exclusions from the definition of proprietary trading have also been expanded to permit any purchase or sale of one or more financial instruments by a banking entity that is acting solely as agent, broker, or custodian.[13]

- ***Employee Benefit Plan***. There is also a new carve out from the definition of proprietary trading for 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 that is established and administered in accordance with the law of the United States or a foreign sovereign, 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.[14]

- ***Acquisition in Satisfaction of a Debt Previously Contracted***. Finally, the definition of proprietary trading does not include a purchase or sale of one or more financial instruments 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 within the holding period otherwise allowed by applicable law.[15] In the Preamble, the Agencies explained that this exclusion will permit banking entities, including SEC-registered broker dealers, to continue to provide margin loans and to take possession of collateral following customer default.[16]

Q-3: What is the trading account?

For purposes of the bar on proprietary trading, a trading account refers to the following three types of activities (regardless of the existence of an actual account):[17]

- Purchases or sales of financial instruments principally for short-term purposes (whether resale, price movements, or arbitrage) or hedging financial instruments used for such purposes);

- Purchases or sales of financial instruments that are covered positions for purposes of the federal banking agencies' market risk capital rule;

- Purchases or sales of financial instruments for any purpose, if the banking entity is registered as or engaged 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 of such business.

The definition of "trading account" also includes a rebuttable presumption under which the purchase or sale of a financial instrument by a banking entity is presumed to be for short-term purposes if the banking entity holds the financial instrument for fewer than sixty days or substantially transfers the risk of the financial instrument within sixty days of the purchase or sale.[18] This presumption can be rebutted if the banking entity demonstrates, based on all relevant facts and circumstances, that the banking entity did not purchase or sell the financial instrument principally for the purpose of short-term resale, benefitting from actual or expected short-term price movements, or realizing short-term arbitrage profits. However, there is no "reverse presumption" that financial instruments held for more than sixty days were not acquired with short-term intent.

Q-4: What types of financial instruments are subject to the ban on proprietary trading?

The following types of instruments are "financial instruments" subject to the restriction on proprietary trading:[19]

- A security, including an option on a security.

- A derivative, including an option on a derivative.

- A contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery.

However, the term "financial instrument" does *not* include:[20]

- A loan, where the term "loan" means any loan, lease, extension of credit or secured or unsecured receivable that *is not a security* (as defined for purposes of Section 3(a)(10) of the Securities Exchange Act of 1934, as amended (the "*Exchange Act*")) *or a derivative*.[21]

- A commodity *that is not*:

  (i) An excluded commodity (other than foreign exchange or currency);

  (ii) A derivative;

  (iii) A contract of sale of a commodity for future delivery; or

  (iv) An option on a contract of sale of a commodity for future delivery.

- Foreign exchange or currency.

The Agencies pointed out that the exclusion of these types of instruments means that the spot purchase of an excluded commodity would be excluded from the definition of "financial instrument" (and, hence, could not constitute proprietary trading) but that the acquisition of a futures position on the same commodity would not be excluded.[22]

Q-5: What types of underwriting activities are permitted?

The Final Rule provides that while certain underwriting and market making functions do constitute proprietary trading, banking entities should be permitted to undertake such activities.[23] In the Final Rule, the Agencies expanded the underwriting exemption "to better capture the broad range of capital-raising activities facilitated by banking entities acting as underwriters on behalf of issuers and selling security holders."[24]

A banking entity may engage in underwriting activities that meet the following requirements:

- ***Definition of Underwriting Position, Distribution and Underwriter***. The banking entity must act as an underwriter for a distribution of securities and the trading desk's underwriting position must be related to such distribution. In the Preamble, the Agencies explained that this requirement was refined in several key respects from a similar requirement contained in the Proposed Rule. In particular, rather than referring to a requirement that a "purchase or sale" of a security be effected "solely in connection with" a distribution, the Final Rule refers to an "underwriting position" to clarify that the exemption focuses on the positions in one or more securities held by a banking entity in connection with a particular distribution of securities rather than requiring a transaction-by-transaction analysis of each security held.[25] The Agencies also explained that elimination of the "solely in connection with" language in the Final Rule is intended make it clear that activities such as stabilization activities, syndicate shorting and aftermarket short covering, holding an unsold allotment when market conditions make it impractical to sell the entire allotment at a reasonable price at the time of distribution and helping an issuer mitigate its risk exposure arising from a distribution of its securities may be permitted under the underwriting exemption.[26] However, the Agencies cautioned that activities that "are not core to the underwriting function" are not covered by the exemption. Note that such activities could potentially be covered by another exemption.[27]

The Final Rule also includes a definition of the term "distribution," which now clearly covers all offerings pursuant to an effective registration statement under the Securities Act of 1933 (the "*Securities Act*"), as well as unregistered offerings that are distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods, which the Agencies observed would include private placements (including those designed to permit resales under Rule 144A) and commercial paper offerings that might involve securities but not be within a separate exemption; however, they observed that bridge financings would need to be examined on a case-by-case basis to determine whether the exemption is available.[28] The Agencies eliminated the requirement in the Proposed Rule that the "magnitude" of the offering distinguish the offering from an ordinary transaction.[29]

The Agencies also slightly modified the definition of "underwriter" from the definition provided in the Proposed Rule to, among other things, better capture selling group members.[30] As defined in the Final Rule, an "underwriter" is:

(i) A person who has agreed with an issuer or selling security holder to (1) purchase securities from the issuer or selling security holder for distribution, (2) engage in a distribution of securities for or on behalf of the issuer or selling security holder, or (3) manage a distribution of securities for or on behalf of the issuer or selling security holder; or

(ii) A person who has agreed to participate or is participating in a distribution of such securities for or on behalf of the issuer or selling security holder.

- ***Near-term Demands of Clients***. The amount and type of the securities in the trading desk's underwriting position must be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and the banking entity must make reasonable efforts 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. In the Preamble, the Agencies explained that this requirement is not intended to preclude a trading desk from distributing an offering over a reasonable period of time or from retaining an unsold allotment where holding such securities is necessary due to the circumstances, such as less than expected customer demand. However, the banking entity would be required to make reasonable efforts to sell or otherwise reduce its position.[31]

- ***Compliance Program and Other Requirements***. The banking entity must establish and implement, maintain, and enforce an internal compliance program that is reasonably designed to ensure the banking entity's compliance with the requirements of the underwriting exemption, including reasonably designed written policies and procedures, internal controls, analysis and independent testing. For additional details, see Q-14.The compensation arrangements of persons performing exempted underwriting activities must be designed not to reward or incentivize prohibited proprietary trading, and incentives should "primarily reward client revenues and effective client services, not prohibited proprietary trading."[32] In the Preamble, the Agencies explained that they do not intend to preclude a banking entity from compensating its employees for successful underwriting.[33] In addition, the banking entity must be licensed or registered to engage in underwriting activities in accordance with applicable law.

Notably, the underwriting exemption in the Final Rule does not include the requirement in the Proposed Rule that a banking entity's underwriting activities be designed to generate revenues primarily from fees, commissions, underwriting spreads or other income not attributable to appreciation in the value of covered financial positions or hedging of such positions.[34]

Q-6: What types of market making activities are permitted?

The Agencies observed that they had been charged with "[allowing] market making, which is important to well-functioning markets as well as to the economy, and simultaneously [prohibiting] proprietary trading, unrelated to market making or other permitted activities, that poses significant risks to banking entities and the financial system."[35] Accordingly, in the Final Rule they permit a banking entity's market making-related activities, subject to certain conditions.[36] In general, the Final Rule eliminates certain specific requirements in the proposed rule and focuses on (i) differences across asset classes and markets, (ii) analyzing the "financial exposure" and "market-maker inventory" held by a trading desk (rather than transaction-by-transaction analysis), (iii) the operational functions of a "trading desk (rather than its legal structure or status); and (iv) the following requirements:

- "***Stand Ready***." The trading desk that establishes and manages a financial exposure must routinely stand ready to purchase and sell one or more types of financial instruments related to its financial exposure and be 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. For purposes of this requirement, "financial exposure" means the aggregate risks of one or more financial instruments and any associated loans, commodities, or foreign exchange or currency, held by a banking entity or its affiliates and managed by a particular trading desk as part of the trading desk's market making-related activities. Notably, the Final Rule does not include the requirement in the Proposed Rule that a trading desk hold itself out as being willing to buy and sell on a regular or continuous basis.[37] In the Preamble, the Agencies explained that "[t]he requirement to routinely stand ready to buy and sell . . . recognizes that market making activities differ based on the liquidity, maturity and depth of the market for the relevant financial instrument."[38] They also explained that "a trading desk acting as a market maker in highly liquid markets would engage in more regular quoting activity than a market maker in less liquid markets"[39] and that "market makers in highly illiquid markets may trade only intermittently or at the request of particular customers."[40]

- ***Near-term Demands of Clients***. The amount, types, and risks of the financial instruments in the trading desk's market-maker inventory must be designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, based on: (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 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. For purposes of this requirement, "market-maker inventory" means all of the positions in the financial instruments for which the trading desk stands ready to make a market that are managed by the trading desk, including the trading desk's open positions or exposures arising from open transactions.

- ***Compliance Program and Other Requirements.*** The banking entity must establish and implement, maintain, and enforce an internal compliance program that is reasonably designed to ensure the banking entity's compliance with the requirements of the market making exemption, including reasonably designed written policies and procedures, internal controls, analysis and independent testing. See Q-14 below. To the extent that any limit identified in the banking entity's compliance policy is exceeded, the trading desk must take action to bring the trading desk into compliance with the limits as promptly as possible after the limit is exceeded. As with the underwriting exemption, the compensation arrangements of persons performing exempted market making activities must be designed not to reward or incentivize prohibited proprietary trading. Finally, the banking entity must be licensed or registered to engage in market making activities in accordance with applicable law.

For purposes of the market making exemption, the terms "client," "customer," and "counterparty," on a collective or individual basis refer to market participants that make use of the banking entity's market making-related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services, subject to certain limitations described in the Final Rule. In particular, the Final Rule includes a presumption that a trading desk or other organizational unit of another banking entity is not a client, customer, or counterparty if that other entity has trading assets and liabilities of $50 billion or more as measured in accordance with standards prescribed in the Final Rule. However, this presumption may be rebutted in certain circumstances, and it does not apply in the case of a purchase or sale conducted anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants. In addition, the Agencies noted that, "with respect to a banking entity that acts as a primary dealer (or functional equivalent) for a sovereign government, the sovereign government and its central bank are each a client, customer, or counterparty for purposes of the market-making exemption as well as the underwriting exemption."[41]

Notably, as with the underwriting exemption, the Final Rule does not include the requirement in the Proposed Rule that a trading desk's market making activities be designed to generate revenues primarily from fees, commissions, bid-ask spreads or other income not attributable to appreciation in value of a financial instrument or hedging.[42] The Final Rule also does not include Appendix B to the Proposed Rule, which set forth proposed commentary regarding the identification of permitted market making activities.[43]

Q-7: What types of risk-mitigating hedging activities are permitted?

Focusing on the need to ensure that hedging is "risk-reducing in nature and not designed to mask prohibited proprietary trading,"[44] the Agencies adopted a "multi-faceted" approach to implementing the exemption that permits a banking entity to engage in risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings. Under the Final Rule, such activity must meet the following requirements:[45]

- ***Compliance Program***. The banking entity must establish, implement, maintain and enforce an internal compliance program that is reasonably designed to ensure the banking entity's compliance with the requirements of the risk mitigating hedging exemption and that meets certain requirements described in the Final Rule. Among other requirements, the banking entity must conduct analysis, including correlation analysis, and independent testing designed to ensure that the positions, techniques and strategies that may be used for hedging may reasonably be expected to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks being hedged, and this correlation analysis must demonstrate that the hedging activity demonstrably reduces or otherwise significantly mitigates the specific, identifiable risks being hedged.

  The risk-mitigating hedging activity must be conducted in accordance with the required written policies, procedures, and internal controls.

- ***Designed to Hedge Identifiable Risks***. At the inception of the hedging activity, including, without limitation, any adjustments to the hedging activity, the hedging activity must be designed to reduce or otherwise significantly mitigate and demonstrably reduce or otherwise significantly mitigate one or more specific, identifiable risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or similar risks, arising in connection with and related to identified positions, contracts, or other holdings of the banking entity, based upon the facts and circumstances of the identified underlying and hedging positions, contracts or other holdings and the risks and liquidity thereof. In addition, the hedging activity must not create, at the inception of the hedge, any significant new or additional risk that is not itself hedged contemporaneously.

- ***Monitoring, Review and Recalibration***. The hedging activity must be made subject to continuing review, monitoring and management by the banking entity in a manner consistent with the required written hedging policies and procedures and that is designed to reduce or otherwise significantly mitigate and demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks that develop over time from the risk-mitigating hedging activities and the underlying positions, contracts, and other holdings of the banking entity, based upon the facts and circumstances of the underlying and hedging positions, contracts and other holdings of the banking entity and the risks and liquidity thereof. Furthermore, a banking entity must engage in ongoing recalibration of hedging activity to ensure that the hedging activity satisfies the requirements of the risk mitigating hedging exemption and is not prohibited proprietary trading. Finally, as with the underwriting and market-making exemptions, the compensation arrangements of persons performing risk-mitigating hedging activities must not be designed to reward or incentivize prohibited proprietary trading.

In the Preamble, the Agencies confirmed that the risk-mitigating hedging exemption "implements the statutory language providing for risk-mitigating hedging related to individual or aggregated positions"[46] and that the Final Rule "does not prohibit anticipatory hedging."[47]

The Final Rule imposes certain additional documentation and record keeping requirements for risk mitigating hedging activities.

Q-8: What types of trading in domestic and foreign government obligations are permitted?

The prohibition on proprietary trading does not apply to the purchase or sale by a banking entity of certain financial instruments, including:[48]

- 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 (including pass-through or participation certificates issued or guaranteed by a government-sponsored entity (such as the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation)).

- An obligation of any State or any political subdivision thereof, including any municipal security.

Notably, the definition of "municipal security" in the Final Rule includes "a security that is a direct obligation of or issued by, or an obligation guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States or political subdivisions thereof."[49]

The proprietary trading ban also does not apply to the purchase or sale of a foreign sovereign obligation by a banking entity that is organized under the laws of a foreign country or that is controlled by a banking entity organized under the laws of a foreign country, provided that the banking entity (i) is not directly or indirectly controlled by a top-tier U.S. banking entity, (ii) the financial instrument is an obligation of, or issued or guaranteed by the foreign country under whose laws the foreign banking entity is organized, and (iii) the purchase or sale as principal is not made by an insured depository institution.[50]

The Final Rule also provides an exemption that allows a foreign bank subsidiary or foreign securities dealer subsidiary of a U.S. banking entity to purchase or sell a financial instrument that is an obligation of or issued or guaranteed by the foreign country under whose laws the foreign entity is organized, or any agency or political subdivision thereof, provided that 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 the laws of the United States or any state.[51]

This exemption does not apply to proprietary trading of derivatives on government obligations.[52]

Q-9: What types of trading on behalf of customers are permitted?

The Final Rule includes express exemptions from the bar on proprietary trading to allow banking entities to use their own funds to purchase or sell financial instruments when acting on behalf of clients or customers in the following classes of transactions:

- ***Fiduciary Transactions***. The Final Rule permits the purchase or sale of financial instruments by a banking entity acting as trustee or in a similar fiduciary capacity, so long as (i) the transaction is conducted for the account of, or on behalf of, a customer; and (ii) the banking entity does not have or retain beneficial ownership (which is not defined) of the financial instruments.[53] The Final Rule does not provide a separate exemption for investment advisers or commodity trading advisors, but the Agencies noted in the Preamble that investment advisers generally act in a fiduciary capacity and the relationship between a commodity trading advisor and its clients or customers can vary and requires assessment based on the particular facts and circumstances."[54]

- ***Riskless Principal Transactions***. The Final Rule also allows the purchase or sale of financial instruments by a banking entity 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.[55]

Q-10: How do the limitations on proprietary trading apply to a regulated insurance company?

The Final Rule includes an exemption that permits a banking entity that is an insurance company or an affiliate of an insurance company to purchase or sell financial instruments for the general account of the insurance company or a separate account established by the insurance company.[56] However, the transaction must be conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the state or jurisdiction in which such insurance company is domiciled, and the appropriate federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the states and foreign jurisdictions, as appropriate, must not have jointly determined, after notice and comment, that such insurance investment law, regulation, or written guidance is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States.

Q-11: Does the ban on proprietary trading apply outside of the United States?

The Volcker rule's ban on proprietary trading applies on a global basis with respect to U.S. banking entities, and it generally applies to activities conducted in the United States or through a U.S. branch or subsidiary by a non-U.S. banking entity. However, the Final Rule includes an exemption for non-U.S. banking entities with respect to their trading activities outside of the United States.[57] Specifically, the ban on proprietary trading does not apply to the purchase or sale of financial instruments by a banking entity if the following requirements have been met:

- The banking entity is not organized or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of any state.

- The purchase or sale by the banking entity is made pursuant to Section 4(c)(9) or Section 4(c)(13) of the BHC Act. Under the Final Rule, a purchase or sale of financial instruments by a banking entity will be considered to have been made pursuant to Section 4(c)(9) or Section 4(c)(13) of the BHC Act, in the case of a foreign banking organization, if the banking entity is a qualifying foreign banking organization (a "QFBO") or, in the case of a banking entity that is not a foreign banking organization, the banking entity is not organized under the laws of the United States or of any State and the banking entity, on a fully-consolidated basis, meets requirements similar to those that apply to qualify as a QFBO. In general, to be treated as a QFBO, a foreign banking organization must demonstrate that more than half of its worldwide business is banking and that more than half of its banking business is outside the United States.

- The banking entity must conduct its activities with respect to the exemption outside of the United States. Specifically, a banking entity engaging as principal in the purchase or sale (including any personnel of the banking entity or its affiliate that arrange, negotiate or execute such purchase or sale) may not be located in the United States or organized under the laws of the United States or of any state. In addition, the banking entity (including relevant personnel) that makes the decision to purchase or sell as principal may not be located in the United States or organized under the laws of the United States or of any state. Further, the purchase or sale, including any transaction arising from risk-mitigating hedging related to the instruments purchased or sold, may not be accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any state.

- No branch or affiliate that is located in the United States or organized under the laws of the United States or any state may provide any financing for the banking entity's purchases or sales of financial instruments outside of the United States.

- The transactions must be conducted in accordance with certain additional requirements that limit the role of U.S. entities. In particular, the purchase or sale may not be conducted with or through any U.S. entity, other than (i) the foreign operations of a U.S. entity if no personnel of such U.S. entity that are located in the United States are involved in the arrangement, negotiation, or execution of such purchase or sale, (ii) an unaffiliated market intermediary 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, (iii) 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.

The definition of U.S. entity for purposes of this exemption is broad and includes any entity that is, or is controlled by, or is acting on behalf of, or at the direction of, any other entity that is, located in the United States or organized under the laws of the United States or any state. In addition, 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 that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary.

Q-12: Does the Volcker rule address material conflicts of interest?

Notwithstanding the exemptions for certain types of transactions involving covered funds, the Volcker rule provides that no transaction, class of transactions or activity may be permitted if it would:

- Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;
- Result, directly or indirectly, 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 to the financial stability of the United States.[58]

Under the Final Rule, unless a banking entity takes certain mitigating actions, a material conflict of interest exists between a banking entity and its clients, customers, or counterparties 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 of transactions, or activity.[59] To mitigate a conflict of interest, prior to effecting a specific transaction or class or type of transactions, or engaging in the specific activity, a banking entity may give clear, timely, and effective disclosure of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest.[60] Such disclosure must be made in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest.[61] Alternatively, a banking entity may establish, maintain, and enforce information barriers that are memorialized in written policies and procedures, such as physical separation of personnel, or functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. However, a banking entity may not rely on such information barriers if, in the case of any specific transaction, class or type of transactions or activity, the banking entity knows or should reasonably know that, notwithstanding the banking entity's establishment of information barriers, the conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty.[62]

The Final Rule defines a high-risk asset as an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States. It defines a high-risk trading strategy as 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 would pose a threat to the financial stability of the United States.[63]

Q-13: How onerous is the metrics reporting requirement?

The Final Rule requires banking entities that engage in significant trading activities to furnish to the relevant Agency the following seven quantitative measurements (reduced from seventeen in the proposed rule) for each of its trading desks engaged in covered trading activity calculated in accordance with requirements described in an appendix to the Final Rule:[64]

- Risk and Position Limits and Usage
- Risk Factor Sensitivities
- Value-at-Risk (VaR) and Stress VaR
- Comprehensive Profit and Loss Attribution

- Inventory Turnover
- Inventory Aging
- Customer Facing Trade Ratio

Banking entities that, together with their affiliates and subsidiaries, have trading assets and liabilities the average gross sum of which equal or exceed $50 billion on a worldwide consolidated basis over the previous four calendar quarters (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) will need to comply with the metrics reporting requiring beginning June 30, 2014. Banking entities with $25 billion or more in trading assets and liabilities and banking entities with $10 billion or more in trading assets and liabilities would also need to comply with the metrics reporting requirement beginning on April 30, 2016, and December 31, 2016, respectively.[65]

In general, banking entities subject to the metrics reporting requirement will be required to calculate any applicable measurement for each trading day. The largest banking entities with $50 billion in consolidated trading assets and liabilities will be subject to a monthly reporting requirement, while other banking entities subject to the reporting requirement will need to report on a quarterly basis.

Q-14: What compliance program does a banking entity need to maintain?

Section __.20 of the Final Rule requires each banking entity engaged in activities subject to the Volcker rule to develop and administer a compliance program that is reasonably designed to ensure compliance with the Volcker rule. The compliance procedures must, at a minimum, include written policies and procedures, internal controls, a management framework that delineates responsibility and accountability for compliance, independent testing and audit, training and maintenance of certain records for at least five years.

In addition, banking entities that engage in significant proprietary trading and that are subject to metric reporting requirements, banking entities that reported total consolidated assets as of the previous year end of $50 billion or more (or, in the case of a foreign banking entity, total U.S. assets of $50 billion or more), and other banking entities designated by an appropriate regulatory agency will become subject to additional compliance program standards described in an appendix to the Final Rule.[66] In general, the compliance program must meet the following requirements:

- The program must be reasonably designed to identify, document, monitor, and report the permitted trading and covered fund activities and investments of the banking entity; identify, monitor and promptly address the risks of these covered activities and investments and potential areas of noncompliance; and prevent activities or investments prohibited by, or that do not comply with, the Volcker rule.
- The program must establish and enforce appropriate limits on the covered activities and investments of the banking entity, including limits on the size, scope, complexity, and risks of the individual activities or investments consistent with the requirements of the Volcker rule.
- The compliance program must be subject to periodic independent review and testing to ensure that the entity's internal audit, corporate compliance and internal control functions involved in review and testing are effective and independent.
- The compliance program must make senior management, and others as appropriate, accountable for the effective implementation of the compliance program, and ensure that the board of directors and chief executive officer (or equivalent) of the banking entity review the effectiveness of the compliance program; and
- Facilitate supervision and examination by the Agencies of the banking entity's covered activities.

Several aspects of the compliance program requirement apply specifically to trading activities. For example, a banking entity must have written policies and procedures governing each trading desk that describe the trading desk's activities, establish the permissibility of such activities under the Volcker rule and address various risk management and compliance issues related to such activities. The enhanced compliance program must also include a comprehensive description of the risk management program for the banking entity's trading activities, establish appropriate limits and internal controls for each trading desk, establish policies and procedures related to hedging activities, and require the banking entity to perform various analysis, quantitative measurements and testing.

The banking entity's internal controls must also be reasonably designed and established to effectively monitor and identify for further analysis any trading activity that may indicate a potential violation. The compliance program must properly document, address and remedy any such violations and must document all proposed and actual remediation efforts. It must also include written policies and procedures to assess whether modifications to the compliance program are warranted and to ensure that appropriate modifications are implemented.

Similarly, a banking entity is required to establish, maintain, and enforce a governance and management framework reasonably designed to ensure that appropriate personnel are responsible and accountable for the effective implementation and enforcement of the compliance program, that a clear reporting line is delineated, and that the compliance program is reviewed periodically by senior management. The compliance program, which must be approved by the board of directors (or appropriate committee thereof) and by senior management, must provide for prompt notification to both senior management and the board of directors of any material weakness or significant deficiencies in the design or implementation of the compliance program. The board of directors and senior management should, under the governance and management framework, have the appropriate authority and access to personnel and information within the organization, and appropriate resources, to conduct their oversight activities effectively. Various provisions require the designation and accountability of appropriate senior management and business line managers with responsibility for each trading desk and organizational unit engaged in covered fund activities.

Finally, the board of directors and senior management are held responsible for setting and communicating a culture of compliance. This includes ensuring that senior management is fully capable, qualified, and properly motivated to manage compliance, and ensuring that senior management has established appropriate incentives and adequate resources to support compliance. Importantly, the bank's entity CEO must attest in writing, on an annual basis, that the banking entity has in place processes to establish, maintain, enforce, review, test, and modify the compliance program in a manner reasonably designed to achieve compliance with the Volcker rule and the Final Rule.

Q-15: How does the ban on proprietary trading affect community banks?

The federal banking agencies issued a document entitled "The Volcker Rule: Community Bank Applicability" in which they asserted that "[t]he vast majority of . . . community banks [with less than $10 billion in total consolidated assets] have little or no involvement in prohibited proprietary trading or investment activities in covered funds" and that these community banks would "not have any compliance obligations under the Final Rule if they do not engage in any covered activities other than trading in certain government, agency, State or municipal obligations." Community banking organizations that do engage in trading activities subject to the Volcker rule will need to conform those activities to the requirements of the Volker rule prior to the conformance period**]** The Final Rule provides that a banking entity with total consolidated assets of $10 billion or less as of December 31 of the previous two calendar years that engaged in activities subject to the Volcker rule may satisfy the compliance program requirement by including in its existing policies and procedures appropriate references to the Volcker rule as appropriate given the activities, size, scope and complexity of the banking entity.

Q-16: When does the Volcker rule take effect?

The Volcker rule became effective on July 21, 2012, but the statute provides for a two year conformance period and permits the Federal Reserve Board to extend the conformance period for up to three, one year periods. In connection with the issuance of the Final Rule, the Federal Reserve Board extended the conformance period, by one year, until July 21, 2015. During the conformance period, banking entities may continue to engage in activities covered by the Volcker rule. However, a banking entity must engage in good-faith efforts, appropriate for its activities and investments, that will result in conformance of all activities and investments to the requirements of the Volcker rule by the end of the conformance period. In its order granting an extension of the conformance period, the Federal Reserve Board explained that such good faith efforts include evaluating the extent to which a banking entity's activities and investments are covered by the Volcker rule as well as developing and implementing an appropriately tailored conformance plan. The Federal Reserve Board also cautioned that banking entities should not expand their activities with the expectation that additional time to conform those activities to the requirements of the Volcker rule may be granted. The Federal Reserve Board previously issued rules addressing the manner in which a banking entity may request additional time to conform to the Volcker rule.[67]

For further information, please contact:

William E. Stern wstern@goodwinprocter.com 212.813.8890

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[1] *See* 12 U.S.C. § 1851(h)(1).
[2] *See* Final Rule at § __.2(c)(2)(i) and (ii).
[3] *See* 12 U.S.C. § 1851(a)(2).
[4] The Agencies other than the CFTC issued a proposed Volcker rule implementing regulation in November 2011 (*See* 76 Fed. Reg. 68,846 (Nov. 7, 2011), and the CFTC issued a substantially similar proposed rule in February 2012 (*See* 77 Fed. Reg. 8,332 (Feb. 14, 2012) (referred to collectively as the "Proposed Rule").
[5] Final Rule at § __.3(d)(1).
[6] Preamble at pg. 57.
[7] Final Rule at § __.3(d)(2).
[8] Preamble at pg. 60.
[9] Final Rule at § __.3(d)(3).
[10] Final Rule at § __.3(d)(4).
[11] Final Rule at § __.3(d)(5).
[12] Final Rule at § __.3(d)(6).
[13] Final Rule at § __.3(d)(7).
[14] Final Rule at § __.3(d)(8).
[15] Final Rule at § __.3(d)(9).
[16] Preamble at pg. 79.
[17] Final Rule at § __3(b)(1).
[18] Final Rule at § __.3(b)(2).
[19] Final Rule at § __.3(c)(1).
[20] Final Rule at § __.3(c)(2).
[21] Final Rule at § __.2(s).

22 Preamble at pg. 54.
23 Final Rule at § __.4(a).
24 Preamble at pg. 84.
25 Preamble at pg. 101.
26 Preamble at pg. 112.
27 Preamble at pg. 113.
28 Preamble at pg. 103.
29 Preamble at pgs. 104-105.
30 Preamble at pg. 107.
31 Preamble at pg. 122.
32 Preamble at pg. 132.
33 Preamble at pg. 132.
34 Preamble at pg. 136.
35 Preamble at pg. 140.
36 Final Rule at § __.4(b).
37 Preamble at pg. 187.
38 Preamble at pg. 208.
39 Preamble at pg. 208.
40 Preamble at pg. 209.
41 Preamble at pg. 247.
42 Preamble at pg. 304.
43 Preamble at pg. 316.
44 Preamble at pg. 324.
45 Final Rule at § __.5.
46 Preamble at pg. 344.
47 Preamble at pg. 353.
48 Final Rule at § __.6(a).
49 Final Rule at § __.3(e)(12).
50 Final Rule at § __.6(b).
51 Final Rule at § __.6(b)(2).
52 Preamble at pg. 364.
53 Final Rule at § __.6(c)(1).
54 Preamble at pg. 396.
55 Final Rule at § __.6(c)(2).
56 Final Rule at § __.6(d).
57 Final Rule at § __.6(e).
58 Final Rule at § __.7(a).
59 Final Rule at § __.7(b)(1).
60 Final Rule at § __.7(b)(2)(i)(A).
61 Final Rule at §__.7(b)(2)(i)(B).
62 Final Rule at § __.7(b)(2)(ii).
63 Final Rule at § __.7(c).
64 Final Rule at App. A.
65 Final Rule at § __.20(d)(3).
66 Final Rule at § __.20(c); Final Rule at Appendix B.
67 See 12 C.F.R. § 225.181.