Proprietary Trading Restrictions Under the Proposed Regulations

Finance industry participants have expressed concern over 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 proposed regulations impose significant new recordkeeping and reporting requirements to provide data for banking entities and regulators to police the boundaries between prohibited proprietary trading and permitted activities. In the proposed regulations, the agencies have provided exceptions prescribed by statute to the prohibition against proprietary trading, with the objective of allowing banking entities to continue to provide traditional client-oriented financial services, including underwriting, market making and asset management services, and to engage in hedging and liquidity management activities designed to enhance the safety of their operations.[2] Regulators face considerable pressure from the financial services industry to preserve the scope of these activities, which are difficult to distinguish, both in regulatory language and in practice, from the prohibited proprietary trading activities.

These challenges have been compounded by the level of interagency cooperation required for the formulation of the proposed regulations.[3] Representatives of individual agencies involved in the rulemaking process have publicly expressed reservations about the end result.[4] Moreover, the Commodity Futures Trading Commission (CFTC), the agency that will develop and enforce the new regulatory regime for swap transactions imposed by the Dodd-Frank Act, did not join in issuing the proposed regulations and is expected to adopt its own version of the Volcker Rule.[5] The CFTC will enforce its formulation of the Volcker Rule with respect to entities for which the CFTC is the "primary financial regulatory agency."[6] Its abstention illustrates the difficulties the agencies would face in assembling and maintaining a consistent regulatory and enforcement approach, especially in areas where the regulatory boundaries between the CFTC and banking agencies are not well defined. In a regulatory area as complex and nuanced as this one, enforcement would be especially vulnerable to localized failures of will or of budget.

Despite the volume and specificity of the proposed regulations, these difficulties make it unlikely that the proposed regulations, as released, are in their final form. The agencies signaled that revisions are likely by including requests for public comment on hundreds of topics bearing on virtually every aspect of the regulations. The public comment period will end on January 13, 2012.

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[1] *See, e.g.*, Letter from Sec. Indus. & Fin. Mkts. Ass'n to Fin. Stability Oversight Council 13 (Nov. 5, 2010), *available at* http://www.sifma.org/workarea/downloadasset.aspx?id=22126; *Global Investment Banks: Regulatory Arbitrage Series: OW European over US IBs*, J.P. Morgan Cazenove, 22 (2011), https://mm.jpmorgan.com/stp/t/c.do?i=5930E-12&u=a_p*d_558208.pdf*h_-2igf3ms.

[2] Proposed Regulations §§ __.4 - __.6.

[3] *See* Notice at 6-7 ("Authority for developing and adopting regulations to implement the prohibitions and restrictions of [the Volcker Rule] is divided between the [multiple agencies] … The statute also requires the [a]gencies, in developing and issuing implementing rules, to consult and coordinate with each other, as appropriate, for the purposes of assuring, to the extent possible, that such rules are comparable and provide for consistent application and implementation of the applicable provisions.").

[4] *See* Ben Protess, *Volcker Rule Divides Regulators*, N.Y. Times Dealbook (Oct. 16, 2011), http://dealbook.nytimes.com/2011/10/16/volcker-rule-divides-regulators/.

[5] *See* Skadden, Arps, Slate, Meagher & Flom LLP, *Title VII of the Dodd-Frank Act One Year Later: Piecing Together the Dodd-Frank 'Mosaic' for Derivatives Regulation* 21-22 (2011), *available at* http://www.skadden.com/newsletters/Title_VII_of_the_Dodd-Frank_Act_One_Year_Later.pdf.

[6] The CFTC is the primary financial regulatory agency for futures commission merchants, commodity pool operators, commodity trading advisors and other entities, with respect to activities that require such entities to be registered under the Commodity Exchange Act. Dodd-Frank Act § 2(12)(C), 12 U.S.C. § 5301(12)(C).

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Application of Regulations

"Covered banking entities" are subject to the proposed regulations. A covered banking entity is defined separately by each issuing agency to describe the application of the regulations to the specific banking entities within its purview.[7] The proposed regulations define banking entity to mean:

- 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 or subsidiary of any of the above (other than covered funds organized, offered and held by any of the above or entities controlled by such covered funds).[8]

Prohibited Proprietary Trading

The proposed regulations prohibit covered banking entities from proprietary trading in "covered financial positions." Covered financial positions include long, short, synthetic and other positions in:

- securities;
- derivatives (which include swaps, security-based swaps, commodity forwards, foreign exchange forwards and swaps);
- commodity futures; and
- options on all of the above.[9]

A covered financial position does not include any position that is itself a loan, commodity or currency, including a position obtained via a spot purchase, but would include a derivative, future or option in respect of the same loan, commodity or currency.[10] The proposed regulations include no criteria for identifying a "loan" and no indication of how the determination should be affected by equity-like control or economic features in an instrument denominated as a loan.[11]

The proposed regulations define proprietary trading as engaging as principal (*i.e.*, not as agent, broker or custodian for unrelated third parties) for the trading account of the covered banking entity in any purchase or sale of covered financial positions,[12] with certain exceptions, as described below.[13] The proposed

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[7] These definitions are set out in the agency-specific text at the end of the Proposed Regulations. *See* Proposed Regulations § 44.2(j) (to be codified at 12 C.F.R. 44.2(j)) (OCC proposed definition); Proposed Regulations § __.2(j) (Federal Reserve proposed definition); Proposed Regulations § 351.2(j) (to be codified at 12 C.F.R. § 351.2(j)) (FDIC proposed definition); Proposed Regulations § 225.2(j) (to be codified at 12 C.F.R. § 225.2(j)) (proposed SEC definition).

[8] Proposed Regulations § __.2(e).

[9] *Id.* § __.3(b)(3)(i).

[10] *Id.* § __.3(b)(3)(ii); *see also* Notice at 12.

[11] The agencies in the introduction request public comment concerning the definition of "loan" and whether a "loan" should exclude a security. Notice at 47.

[12] Proposed Regulations § __.3(b)(1).

[13] *See id.* § __.3(b)(2)(iii).

regulations define a "trading account" as any account used by a covered banking entity to acquire or take one or more covered financial positions:

- principally for the purposes 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;
- that are market-risk, capital-rule covered positions if the covered banking entity or any bank holding company affiliate so calculates risk-based capital ratios; or
- in connection with their business as dealers, municipal securities dealers, swap dealers or security-based swap dealers, including dealers engaging in such business outside of the United States.[14]

An account will not be deemed a trading account to the extent it is used for:

- repurchase, reverse repurchase and securities lending agreements;
- the purpose of *bona fide* liquidity management under a qualifying documented liquidity management plan to meet near-term liquidity needs; or
- clearing, for covered banking entities that are derivatives clearing organizations or clearing agencies.[15]

Even though the definition of trading account is central to the prohibition against proprietary trading, the proposed regulations have not expressed with any degree of precision what a trading account is intended to encompass. The regulations indicate that an account is a trading account if it is used under certain specified circumstances to "[a]cquire or take one or more" covered financial positions for listed purposes.[16] This represents a change from the language of the statute, which would deem an account to be a trading account if it is "used for acquiring or taking positions" under the specified circumstances.[17] The proposed regulations contain no express requirement to segregate assets, and yet the text of the proposed regulations, taken literally, means that even a single short-term position in an account will make every position in that account (unless subject to an exclusion or exemption) a prohibited position. Given the complexity of modern settlement practices and the diversity of the accounts involved for any major institution, the proposed regulations appear to suggest that the agencies expect covered banking entities to make fundamental changes in their trading account practices.

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[14] *Id.* § __.3(b)(2)(i).

[15] *Id.* § __.3(b)(2)(iii).

[16] *Id.* § __.(3)(b)(2)(i)(A).

[17] Dodd-Frank Act § 619(h)(6), 12 U.S.C. § 1851(h)(6). In contrast, for purposes of the market-risk capital rules, assets and positions are categorized separately from their accounts, and the purpose of the assets themselves (not the account) is determinative (although banks are encouraged to separate their trading assets from other assets), and failure to establish a separate account will not prevent assets from being trading assets. Fed. Fin. Inst. Examination Council, *Instructions for Preparation of Consolidated Reports of Condition and Income* (FFIEC 031 and 041), A-78a to A-79 (2011), *available at* http://www.ffiec.gov/pdf/FFIEC_forms/FFIEC031_FFIEC041_201109_i.pdf.

Permitted *Bona Fide* Liquidity Management Activity

Activities undertaken for *bona fide* liquidity management and in accordance with a documented liquidity management plan would not cause an account to be a trading account. In order to qualify for the liquidity management exclusion, the plan must:

- specifically contemplate and authorize the particular instrument to be used, its profile with respect to market, credit and other risks, and the liquidity circumstances in which the instrument may or must be used;
- require that any transaction contemplated and authorized by the plan be principally for the purposes of managing liquidity and not for any of the prohibited short-term trading purposes;
- require that any position taken be highly liquid and limited to financial instruments which are not expected to give rise to appreciable profits or losses from short-term price movements;
- limit the aggregate of liquidity management positions to an amount that is consistent with the banking entity's near-term funding needs, including deviations from normal operations, as estimated and documented as specified in the plan; and
- be consistent with the applicable regulatory agency's supervisory requirements regarding liquidity management; or
- be taken by a registered derivatives clearing organization or clearing agency in connection with its clearing business.[18]

The applicable regulatory agency will be authorized to review liquidity management plans and transactions through supervisory and examination processes to ensure that they are consistent with the plans. These provisions reflect a concern of the regulators that a banking entity could use financial instruments for short-term trading purposes rather than to ensure that it has liquid assets available to meet its short-term liquidity needs.[19] The requirements are accompanied by a number of requests for public comment regarding current liquidity practices,[20] suggesting that in this area regulators would need to rapidly gain expertise to distinguish permitted transactions from prohibited trading. Banking entities would also need to scramble to assemble liquidity management plans. We anticipate that regulators will find it difficult to articulate principles that allow prudent adaptation to diverse market circumstances, yet are sufficiently specific to facilitate detection of prohibited proprietary trading.

Determining whether positions are taken for short-term purposes would be difficult, especially during periods of market dislocation. Accordingly, the proposed regulations establish a rebuttable presumption that a position (other than the market-risk, capital-rule covered positions or dealing positions described above) that is taken for a period of 60 days or less will cause the related account to be a trading account. The banking entity can overcome this presumption if it demonstrates, based on all the facts and circumstances, that the covered financial position, individually or as a category, was not acquired or taken principally for short-term purposes.[21]

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[18] Proposed Regulations § __.3(b)(2)(iii)(C)(D).

[19] Notice at 38.

[20] *Id.* at 39-41.

[21] Proposed Regulations § __.3(b)(2)(ii).

Finally, the application of the covered financial position definition to the trading programs of regulated institutions may have unintended consequences. By operation of that definition, the proprietary trading restrictions would not apply to a banking entity's position that is itself a loan, commodity or currency. The restrictions would apply, however, to positions in a derivative, future or option in respect of a loan, commodity or currency. In many cases, banking entities will use both types of positions in a unified trading strategy. A banking entity may, for example, effect spot purchases in commodities as part of the same strategy that involves derivatives, futures or options in respect of commodities (which may or may not be hedging related). We question whether such a trading program would remain viable if it is not permitted to include both types of positions. The disparate treatment of these types of positions and the utility of running the programs in a unified manner may drive such trading programs out of covered banking entities and into nonbanks or foreign banks that are not subject to the restrictions.

Permitted Proprietary Trading Activities

As embodied by the Dodd-Frank Act, the Volcker Rule permits banking entities to pursue the following activities, as exceptions to the prohibition against proprietary trading:[22]

- trading in certain government obligations (in order to support markets in those obligations);
- underwriting and market making activities;
- certain risk-mitigating activity;
- trading on behalf of customers;
- trading by a regulated insurance company and its affiliates for the general account of the insurance company;[23] and
- trading outside the U.S. by non-U.S. banking entities.

The Volcker Rule also allows the regulatory agencies to adopt rules permitting other activities if they would promote and protect the safety and soundness and the financial stability of the United States.[24] The proposed regulations contain no such exemptions, although the regulators have requested public comment as to whether any should be adopted.

Permitted Underwriting and Market Making Activity

Consistent with the objective of allowing banking entities to continue to engage in traditional client-oriented financial services, the proposed regulations permit underwriting and market making activities that otherwise would be construed as prohibited proprietary trading.[25] Certain criteria are applicable to both the permitted underwriting and market making activities. First, to utilize either exception to the proprietary trading ban a banking entity must have established the internal compliance program prescribed by

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

[23]For a description of the exception for insurance company general account transactions, see The Proposed Regulations and Insurance Company Investment Activities.

[24]*See* Dodd-Frank Act § 619(d)(1), 12 U.S.C. § 1851(d)(1); *see also* Notice at 81.

[25]Proposed Regulations § __.4(a)-(b).

the proposed regulations.[26] Second, revenues 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.[27] Third, the compensation arrangements of persons who perform underwriting or market making activities must be designed not to encourage or reward proprietary risk-taking.[28]

Internal Compliance Procedures. In addition to compiling and reporting on the quantitative information required by the proposed regulations (discussed below with regard to market making), entities utilizing either the permitted underwriting or market making activity would be required to implement new internal compliance procedures. Under the proposed regulations, each banking entity must establish an internal compliance program that is suitable for the "size, scope and complexity of activities and business structure of the covered banking entity"[29] and that includes the following elements:

- internal written policies and procedures designed to document, describe and monitor covered trading activities (as well as covered fund activities and investments) of the banking entity;
- a system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with the proposed regulations and to prevent the occurrence of prohibited activities;
- a management framework that clearly identifies the parties responsible for compliance and accountability;
- independent testing for the effectiveness of the compliance program, conducted either by qualified personnel or a qualified outside party;
- training for trading personnel, managers and other appropriate personnel; and
- keeping records sufficient to demonstrate compliance.[30]

The introduction to the proposed regulations states that such compliance programs should not be developed by a generic "one-size-fits-all" approach, but rather should be carefully tailored to "take into account and reflect the unique manner in which a banking entity operates, as well as the particular compliance risks and challenges its businesses present."[31] If this requirement is implemented, the compliance regimes may vary considerably among banking entities. The potential costs and administrative impact of such programs within an individual banking entity's operating structure will depend on the extent of the banking entity's underwriting and market making activities and how broadly such activities are conducted throughout its operational structure and thus will be difficult to project.

The proposed regulations do not provide a complete framework for the implementation of compliance programs, but the introduction to the proposed regulations requests public comment as to how the proposed compliance requirement should be implemented and enforced.[32] Prior to the release of the proposed regulations, many industry observers anticipated that the compliance and reporting require-

[26] *Id.* §§ __.4(a)(2)(i) & (b)(2)(i).

[27] *Id.* §§ __.4(a)(2)(vi) & (b)(2)(v).

[28] *Id.* §§ __.4(a)(2)(vii) & (b)(2)(vii).

[29] *Id.* § __.20(a).

[30] *Id.* § __.20(b)(1)-(6).

[31] Notice at 162.

[32] *Id.* at 165-170.

ments would include a mandate for CEO certifications similar to those required under Sarbanes-Oxley.[33] The agencies did not include a requirement for such certifications in the regulations as proposed but have requested public comment about the potential benefits and drawbacks of adding such a requirement.[34]

Revenue Requirements. The proposed regulations require that a banking entity's underwriting or market making activities be designed to generate revenues primarily from fees, commissions, underwriting spreads, bid/ask spreads or other income not attributable to appreciation in the value of the financial positions it holds or from the hedging of covered financial positions.[35] Because the proposed regulations provide no bright-line test for the percentage of revenues that must be derived from fees and commissions rather than from changes in value of securities held as a result of underwriting or market making activities, banking entities attempting to comply with this requirement will face significant challenges in evaluating and interpreting the relevant facts. For example, banking entities may keep more securities in inventory or other retained principal positions, particularly for market making purposes, than the agencies would expect based on average trading volumes, for both publicly traded equity securities and debt and derivatives traded over the counter, either as a matter of ordinary market making practice or unintentionally as a result of shifting market conditions. Retention of such securities for significant periods of time or during periods of high volatility and the realization of income from appreciation in the value of such positions could be construed as proprietary trading under the proposed regulations, even if the positions were in fact established to provide market making inventory.[36] Uncertainty as to what level of revenue or loss from changes in asset value is permissible may limit a banking entity's ability to function as an effective market maker.

Compensation. The proposed regulations require that the compensation arrangements for employees engaged in underwriting or market making activities be designed to discourage proprietary risk-taking.[37] Compensation must be structured to reward client returns and effective client service in the case of underwriting, or timely intermediation and liquidity services to customers in the case of market making, rather than profits from proprietary risk-taking or speculation regarding the market value of a covered financial position held in inventory.[38] In their compensation decisions, banking entities relying on either the permitted underwriting or market making activity may take into account revenues resulting from movements in the prices of securities or other positions held in inventory. However, they can do so only to the extent that such revenues reflect the effectiveness with which personnel have managed underwriting risk or retained principal risk.[39] We expect that banking entities will need to review the compensation structures of the business units engaged in underwriting and market making and may find it necessary to adjust current compensation practices to comply with this requirement. With respect to their ability to retain qualified personnel, such changes may place banking entities at a competitive disadvantage in relation to institutions where compensation practices are not subject to the same constraints.

[33] Sarbanes-Oxley Act of 2002, § 906(a), 18 U.S.C. § 1350.

[34] Notice at 168.

[35] Proposed Regulations §§ __.4(a)(2)(vi) *&* (b)(2)(v).

[36] *See id.* § __.3.

[37] *Id.* §§ __.4(a)(2)(vii) & (b)(2)(vii).

[38] *See* Notice at 50, 60-61.

[39] *Id.*

In examining the trading activity of a business unit of a banking entity to determine whether it provides impermissible compensation incentives that reward proprietary risk-taking, the agencies will evaluate the extent to which compensation incentives reward revenues from movements in the price of retained principal positions and risks, the extent to which compensation incentives reward customer revenues, and the compensation incentives provided by other banking entities to similarly situated personnel.[40]

Permitted Underwriting Activity. The proposed regulations would permit a banking entity to engage in underwriting activities, even if such activities would involve the acquisition of a principal position in a covered security, to the extent that such activities are designed to meet the reasonably expected near-term demand of clients, customers or counterparties.[41] Banking entities must meet the following seven criteria to pursue transactions under this exception to the proprietary trading ban:

- the banking entity must have established the internal compliance program required under the proposed regulations;
- the covered financial position to be purchased or sold by the banking entity must be a security pursuant to Section 3(a)(10) of the Securities Exchange Act of 1934, as amended (the Exchange Act);
- the transaction must be effected solely in connection with a distribution of securities for which the banking entity acts as an underwriter;
- the banking entity must have the appropriate dealer registration or otherwise be exempt from registration or excluded from regulation as a dealer;
- the underwriting activities must be designed to meet, rather than exceed, the reasonably expected near-term demands of clients, customers and counterparties;
- revenues must be derived principally from fees, commissions, underwriting spreads or other similar income; and
- the compensation arrangements of persons who perform underwriting activities must be designed not to encourage proprietary risk-taking.[42]

The proposed regulations define the terms "distribution" and "underwriter" as such terms are defined under Regulation M.[43] The introduction states that, when determining whether a banking entity is acting as an underwriter, the agencies expect to consider the extent to which it is engaged in the following activities:

- 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;

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[40] Proposed Regulations app. B.III.C.5.

[41] *Id.* § __.4(a)(1).

[42] *Id.* § __.4(a)(2)(i)-(vii).

[43] *Id.* § __.4(a)(3)-(4); *see also* Notice at 48-49.

- participating in or organizing a syndicate of investment banks;
- marketing securities; and
- providing a post-issuance secondary market and facilitating price discovery.[44]

The proposed regulations expand the Regulation M definition of "underwriter" to include not only parties which have an agreement with an issuer or selling security holder to purchase securities for distribution or otherwise manage a distribution, but also parties that have agreements with any such Regulation M underwriter to engage in a distribution of securities on behalf of an issuer or selling security holder, such as dealers.[45] In the introduction to the proposed regulations, the agencies also recognize that activities of underwriters often vary depending on the type of securities offered and, therefore, the factors serve as indicia of underwriting rather than a bright-line test.[46]

In the introduction, the agencies acknowledge that, in certain instances, underwriters may hold securities for a prolonged period of time rather than immediately reselling them, typically when they are unable to sell all or a portion of the securities offered in an underwritten transaction. Sale of such securities at a later time is permitted if the original acquisition of the securities occurred in connection with underwriting activities and pursuant to the permitted underwriting activity.[47]

As is the case under Regulation M, to qualify as a "distribution," the offering must be of a certain "magnitude" and involve "special selling efforts and selling methods."[48] In the introduction, the agencies indicate that they expect to utilize the same factors that the SEC considers when evaluating a distribution pursuant to Regulation M. Magnitude may be established by taking into consideration the number of shares to be sold and the percentage of the outstanding shares, public float and trading volume that those shares represent.[49] In the introduction, the agencies note that under Regulation M, this criterion does not require a distribution to be large but rather to be distinguishable from ordinary trading.[50] Accordingly, the definition of distribution under the proposed regulations would not preclude a small offering or private placement from qualifying for the permitted underwriting activity, as long as, on a relative basis, the scale of the offering exceeds ordinary trades of the offered securities.[51] Indicia of special selling efforts and methods include delivering a sales document and conducting road shows. The introduction also indicates that compensation at a level greater than normal for secondary trades but consistent with underwriting compensation is an indicator of special selling efforts and methods.[52] The proposed regulations, however, stop short of providing a bright-line test for compliance by a particular transaction with the distribution component of the permitted underwriting activity.

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[44] Notice at 49.

[45] Proposed Regulations § __.4(a)(4); *see also* Notice at 49.

[46] Notice at 49.

[47] *Id.*

[48] Proposed Regulations § __.4(a)(3); *see also* Notice at 48.

[49] Notice at 48.

[50] *Id.* at 48-49.

[51] *Id.* at 49.

[52] *Id.* at 48.

Permitted Market Making Activity. The proposed regulations permit banking entities to purchase or sell covered financial positions in connection with the banking entity's market making-related activities.[53] The agencies acknowledge the difficulty of distinguishing proprietary positions acquired in the context of market making from those acquired for impermissible speculative purposes.[54] The proposed regulations employ a multifaceted approach to the problem of drawing such distinctions.[55] This multifaceted approach includes a new reporting regime that requires disclosure by banking entities of quantitative measurements relating to their principal investments.[56] Although quantitative metrics are to be used in testing permitted market making activities, the proposed regulations again stop short of providing a bright-line test to evaluate compliance of particular principal transactions.

Banking entities must meet the following requirements to utilize the exception for permitted market making activities:

- the banking entity must have established the internal compliance program required under the proposed regulations (as described below);[57]
- the banking entity must engage in *bona fide* market making activity;
- the market making activity must be designed not to exceed the reasonably expected near-term demands of clients, customers and counterparties;
- the banking entity must register, or be exempt from registration, as a dealer under the securities or commodities laws, as appropriate;
- revenues from the securities transactions in question must be derived principally from fees, commissions, bid/ask spreads or other similar income, rather than gains or losses resulting from market appreciation or appreciation of such security;
- the compensation arrangements for persons who perform market making activities must be designed to compensate for client service rather encourage or reward proprietary risk-taking; and
- the market making activity must be consistent with the guidance in the proposed regulations distinguishing proprietary trading from market making.[58]

The market making exception in its current form may assuage industry concern that the regulations would prevent financial intermediaries, including dealers in over-the-counter derivatives, from accommodating their customers by executing either complex positions or positions with complex hedges. Although the Dodd-Frank Act will require most standardized derivative transactions to be cleared and customers will thus execute many of their hedges through clearing participants, dealers should retain their ability to engage in custom transactions if they meet the requirements for exempted market making activity and hedge promptly and appropriately.

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[53] Proposed Regulations § __.4(b)(1).

[54] *See* Notice at 53.

[55] *See id.* at 53-54.

[56] Proposed Regulations app. A.III.A; *see also* Notice at 54.

[57] *See* Internal Complinace Procedures.

[58] *See* Proposed Regulations § __.4(b)(2).

***Bona Fide* Market Making.** The exception for market making-related activity requires that the relevant banking entity engage in conduct that is considered "*bona fide* market making activity." To satisfy this requirement, a banking entity must hold itself out as being willing to buy and sell, or otherwise enter into long and short positions in, the covered financial position for its own account on a regular or continuous basis, depending on the liquidity of the type of security involved.[59]

The "market maker" definition in the proposed regulations is similar to the definition of market maker under Section 3(a)(38) of the Exchange Act. The introduction to the proposed regulations indicates that the agencies intend to evaluate the presence of *bona fide* market making in a manner similar to that currently used by the SEC to identify market making.[60] The introduction contemplates that, in the context of relatively liquid positions, such as publicly traded equity securities, market making activity generally would include:

- making continuous, two-sided quotes and holding oneself out as willing to buy and sell on a continuous basis;
- a pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity; and
- making continuous quotations that are at or near the market on both sides; and
- providing widely accessible and broadly disseminated quotes.[61]

In the context of less liquid positions, such as debt securities or over-the-counter derivatives, indicators of market making activity will vary but generally will include:

- holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis;
- regularly purchasing covered financial positions from, or selling the positions to, clients, customers or counterparties in the secondary market; and
- transaction volumes and risk proportionate to historical customer liquidity and investment needs.[62]

The introduction to the proposed regulations indicates that *bona fide* permitted market making-related activity will include block positioning if undertaken for the purpose of intermediating customer trading, as well as taking significant block positions in securities in anticipation of customer demand, as long as such anticipatory buying or selling is reasonable and related to clear, demonstrable trading interests of clients, customers or counterparties.[63] However, because compliance with this requirement relies on a standard of "reasonably expected near[-]term demands," it is not clear whether it would be available for significant block positions that may be held on a continuous basis by market makers to facilitate large block trades in otherwise highly liquid securities. To provide liquidity for large block trades, a market maker may be required to hold positions that appear to be beyond the scale necessary to facilitate reasonably expected

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[59]Proposed Regulations § __.4(b)(2)(ii). *See also* Notice at 56-57.

[60]Notice at 56.

[61]*Id.* at 56-57.

[62]*Id.* at 57.

[63]*Id.* at 57-58.

near-term demand, if that expectation is based on the volume of ordinary day-to-day trading. We would hope that the concept of near-term demand will be interpreted in a manner that is sufficiently elastic to accommodate such block trading.

Market making-related hedging transactions also are permissible if they meet two requirements. First, the purpose of the purchase or sale must be to reduce the specific risks to the banking entity related to individual or aggregated positions, contracts or other holdings acquired pursuant to the permitted market making activity.[64] Second, the hedging transaction must satisfy the requirements for the general risk-mitigating permitted hedging activity under the proposed regulations.[65] These criteria are intended to define the scope of permissible risk-mitigating hedging, to foreclose reliance on the exemption for prohibited proprietary trading conducted in the context of, or mischaracterized as, hedging activity, and to require documentation regarding the hedging purpose of certain transactions at a different level of organization than is required for the underlying risks being hedged.[66]

The permitted market making activity is specific both to the trading desk or organizational unit that is actually making the market in the covered financial position and to the type of covered financial position involved, since liquidity varies considerably by type of security. This exception will not permit non-market making trades by trading units that also engage in permitted market making, nor will it cover positions in covered securities taken by a banking entity's non-market making organizational units, even if other organizational units within the banking entity provide market making liquidity.[67]

Reasonably Expected to Meet Near-Term Demands of Clients. Market making-related activities must be reasonably expected to meet the near-term demands of clients, customers and counterparties.[68] The introduction states that expectations of demand should be based on more than a mere expectation of price appreciation and the related generic increase in marketplace demand.[69] The introduction does not provide guidance regarding the consequences to a banking entity that fails to accurately predict near-term demand and, as a result, holds positions in covered securities for periods longer than the typical holding period for the applicable securities.

The agencies have proposed a quantitative component to the analysis of near-term demand. The proposed regulations require the monitoring and reporting of up to 22 quantitative metrics intended to be indicative of whether a trading unit has acquired principal positions for the purpose of market making-related activities.[70] For banking entities that have $5 billion or more of gross trading assets and liabilities, each trading unit engaged in market making-related activity must conduct daily evaluations of 17 quantitative measurements, and all trading units of such banking entities must conduct daily evaluations of five quantitative measurements.[71] The results of such evaluations must be reported on a monthly basis to the relevant agency.[72]

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[64]Proposed Regulations § __.4(b)(3)(i).

[65]*Id.* § __.4(b)(3)(ii); *see also* Permitted Risk-Mitigating Hedging Activity.

[66]Notice at 61.

[67]*Id.* at 56.

[68]Proposed Regulations § __.4(b)(2)(iii).

[69]Notice at 58; *see also* Proposed Regulations app. A.III.A.

[70]Proposed Regulations app. A.III; *see also* Notice at 89.

[71]Proposed Regulations app. A.III.A(i). The reporting metrics are less onerous for banking entities with between $1 and $5 billion of gross trading assets and liabilities. *See Id.* app. A.III.A(ii); *see also* Notice at 89, 90.

[72]Proposed Regulations app. A.III.B.

The specific quantitative metrics fall into the following broad categories:

- risk-management measurements;
- source-of-revenue measurements;
- revenues-relative-to-risk measurements;
- customer-facing activity measurements; and
- payment of fees, commissions and spreads measurements.[73]

The proposed regulations describe these metrics and provide guidance as to how each must be calculated.[74] They do not, however, provide specific quantitative limits that would enable a banking entity to ascertain whether the metrics it reports fall within an appropriate range to qualify as permitted activity. The agencies have requested public comment on whether to incorporate such numerical thresholds for some or all of the quantitative metrics and, if so, what the appropriate thresholds should be.[75]

Even if the agencies were to adopt bright-line metrics, their implementation to evaluate compliance with the market making exemption could have a chilling effect on the ability of banking entities to engage in permissible market making activities. Reporting of the metrics by individual trading units (as currently proposed) would require coordination among participants in active trades to assure that, collectively, trading levels within the institution did not exceed permitted levels on any given day or other measurement period. Given the volume and velocity of transactions that may be executed by active trading units devoted to market making, such coordination may not be feasible or may result in timing or transactional inefficiencies that work in opposition to client-driven market making objectives.

Consistency With Agency Guidance Distinguishing Proprietary Trading From Market Making. To qualify as a permitted activity under the proposed regulations, market making-related activities must be consistent with the guidance provided by the agencies for distinguishing proprietary trading from market making, including the factors described below. Absent "explanatory circumstances,"[76] the presence of any of these six factors would result in a banking entity being deemed to be engaged in proprietary trading:

- trading activity in which a trading unit retains risk in excess of the size and type required to provide intermediation services to customers;
- trading activity in which a trading unit primarily generates revenues from price movements of retained principal positions and risks rather than customer revenues;
- trading activity in which a trading unit generates only very small or very large amounts of revenue per unit of risk taken, does not demonstrate consistent profitability or demonstrates high earnings volatility;
- trading activity in which a trading unit either does not transact through a trading system that interacts with orders of others or primarily with customers of the banking entity's market making desk to

[73] Notice at 92.

[74] Proposed Regulations app. A.III.

[75] Notice at 88.

[76] *Id.* at 99. The introduction to the proposed regulations provides examples of such facts and circumstances. *See id.* at 99-100.

provide liquidity services, or holds principal positions in excess of reasonably expected near-term customer demands;

- trading activity in which a trading unit routinely pays rather than earns fees, commissions or spreads; and
- the use of compensation incentives for employees of a particular trading activity that primarily reward proprietary risk-taking.[77]

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 proposed regulations permit a banking entity to purchase or sell a covered financial position in connection with, related to, and designed to reduce the specific risks associated with, the banking entity's individual or aggregated positions or holdings.[78] As is the case for the underwriting and market making permitted activities, banking entities seeking to engage in permitted hedging activity must have established the required internal compliance program, including robust, detailed hedging policies and procedures designed to prevent prohibited proprietary trading in this context.[79]

Transaction Requirements. If a banking entity seeks to qualify to engage in permitted hedging activity, it will be required to establish that each purchase or sale:

- is made in accordance with the banking entity's written policies, procedures and internal controls established as described above;
- hedges or otherwise mitigates a specific risk arising out of individual or aggregated positions or other holdings of the banking entity;
- 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;
  - maintains a reasonable correlation with the risks intended to be hedged or mitigated; and
  - mitigates any significant exposure arising out of the hedge after inception.

In addition, the compensation arrangements of persons performing the risk-mitigating hedging activities must be designed not to reward proprietary risk-taking.[80]

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[77] Proposed Regulations app. B.III.C.1-6; *see also* Notice at 99-100.

[78] Proposed Regulations § __.5.

[79] *Id.* § __.5(b)(1); *see also* Notice at 65.

[80] Proposed Regulations §§ __.5(b)(2)(ii)-(vi); *see also* Notice at 65-67.

The proposed regulations also impose a documentation requirement for each hedge established at a different a level of organization from that of the underlying exposure. At the time any such hedge is entered into, the banking entity must document, at a minimum, the risk-mitigating purpose of such a hedge, and the risks of the individual or aggregated positions it is designed to reduce.[81]

General Characteristics of Hedging Regulation. The proposed regulations follow the Volcker Rule[82] in allowing hedges of aggregated positions. The agencies, however, have solicited public comment as to whether the proposed regulations could better address strategies and techniques used to hedge aggregated positions.[83]

The requirement that a hedging transaction be reasonably correlated to risks intended to be hedged or mitigated is designed to ensure that banking entities can demonstrate quantitatively that hedging transactions reduce risk in the aggregate. Reasonable correlation does not require perfect correlation with any particular risk, but should take into account the costs and feasibility (including with respect to the liquidity of both the underlying and hedge positions) of effectively hedging a spectrum of associated risks.[84] The regulators note that changing circumstances will require hedges to be adjusted to maintain a reasonable level of correlation and particularly that hedges should be increased or unwound as the underlying exposure increases or decreases.[85] This is consistent with a general view that selective hedging, hedging that introduces new unhedged risks at inception and hedging that has the potential to generate profits in excess of losses that could result from the underlying position are all indicative of proprietary trading.

Similarly, the proposed regulations suggest that the regulators will view deviations from a banking entity's established hedging policies and procedures as a potential indication of proprietary trading. This is reflected specifically in the documentation requirement for a hedge established at a different a level of organization from the underlying exposure.[86] That requirement springs from the regulators' concern that the separation of the hedge and the underlying exposure at different levels of organization may 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.[87] Banking entities, however, may choose to move hedging activities to the level that generated the underlying risks to avoid this additional layer of documentation. In that case, the banking entities may forego the benefit of a more independent internal view of those risks.

Permitted Trading on Behalf of Customers

The proposed regulations permit trading on behalf of customers in which gains and losses flow to the customer and not the banking entity. The following categories of trading are permitted:

- trading in a fiduciary capacity where the customer has beneficial ownership of the positions;

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[81] Proposed Regulations § __.5(c).

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

[83] Notice at 69-71.

[84] The Notice explicitly rejects the FASB hedge accounting standards, which tend to be narrow and quite specific, as being designed for a different purpose and subject to change. Notice at 66.

[85] Proposed Regulations §§ __.5(b)(2)(iii)–(iv); *see also* Notice at 67.

[86] Proposed Regulations § __.5(c).

[87] Notice at 68.

- riskless principal transactions (in which the covered banking entity enters into a purchase or sale of a covered position for its own account to offset a contemporaneous sale to or purchase from a customer);[88] and
- transactions conducted by a banking entity that is a regulated insurance company for the separate account of insurance policyholders.[89]

Overriding Restrictions on Permitted Activities

The proposed regulations include a provision that would prohibit 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;[90]
- result in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy;[91] or
- pose a threat to the safety and soundness of the banking entity or U.S. financial stability.[92]

The proposed definition of material conflict of interest includes 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 proposed regulations embody a regulatory focus on disclosure of conflicts or informational walls to manage conflicts.[93] Little guidance is provided as to what types of transactions could give rise to a material conflict of interest. The introduction to the proposed regulations states that the existence of such a conflict will be evaluated on a facts-and-circumstances basis. It also provides the example of a banking entity that acquires substantial amounts of nonpublic information about the financial condition of a particular company or issuer through its various banking activities which, if improperly shared with its own trading desks and used in its own trading operations, would permit the banking entity to use such information to the disadvantage of its customers, clients or other counterparties.[94] As market making-related hedging transactions that are on opposite sides of the liquidity-generating position are specifically permitted by the proposed regulations,[95] it is unlikely that these types of transactions would constitute a material conflict of interest, although the exact reach of this provision is difficult to project. In light of the recent synthetic CDO settlements and the prospect of these new regulations, however, we can expect dealers to consider potential conflicts more carefully and to require more specific conflict waivers in transaction documentation going forward.

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[88] In the case of the riskless principal transaction exception, the agencies note that the language mirrors the Board's Regulation Y, OCC interpretive letters and the SEC's Rule 3a5-1 under the Exchange Act, implying that the contemporaneous purchase or sale should occur within one business day of the customer transaction. Notice at 74.

[89] Proposed Regulations § __.6(b). The exception for insurance company separate account transactions is described in The Proposed Regulations and Insurance Company Investment Activities.

[90] Proposed Regulations § __.8(a)(1).

[91] *Id.* § __.8(a)(2).

[92] *Id.* § __.8(a)(3).

[93] *See id.* § __.8(b); *see also* Notice at 105.

[94] Notice at 105.

[95] Proposed Regulations § __.5(a).

Compliance Requirements

The proposed regulations include recordkeeping and internal compliance requirements (including external testing) for any covered banking entity that has, together with its affiliates and subsidiaries, trading assets and liabilities of $1 billion or more, with varying degrees of compliance infrastructure depending on the extent to which the entity engages in covered activities. Appendices specify requirements for quantitative measurements, factors for evaluating permitted market making transactions and minimum standards for program compliance.[96]

The proposed regulations attach a high degree of significance to the proportion of the revenues of the regulated entities that is derived from price movements and risk-taking (considered to be associated with prohibited proprietary trading) as opposed to the proportion derived from commissions and fees (considered to be associated with permitted underwriting activity and permitted market making activity). Similarly, the proposed regulations discourage regulated entities from structuring compensation of trading personnel to reward proprietary risk taking. Although these concepts may have intuitive appeal, applying a quantitative basis for this distinction will be difficult and may become more difficult over time, as professionals who receive compensation based on the profitability of their trading units become more adept at structuring their compensation and revenues to correlate with measures other than risk taking.

The proposed regulations rely on the ability of the enhanced compliance program to make difficult factual determinations, especially as to permitted market making, liquidity management and customer accommodation transactions. Because the internal compliance measures would be difficult and costly to implement, these customer-oriented activities may migrate toward a small number of large banks that have the resources to implement them — or be driven from regulated banking entities entirely.

[96] *See id.* § __.7(a), app. A; *see also* Notice at 14, 82, 89-90.