Client Alert

December 27, 2013

The Volcker Rule and Capital Markets Offerings

Summary

Final regulations under the section of the Dodd-Frank Act known as the "Volcker Rule" [1] were enacted in December 2013 (the "Final Rule") by five federal financial regulatory agencies (collectively, the "Agencies"). [2] The Volcker Rule prohibits a banking entity from engaging in proprietary trading and from acquiring or retaining an ownership interest in, or sponsoring, a hedge fund or private equity fund. The Volcker Rule permits certain kinds of trading activity – notably, in connection with underwriting, market making, and risk-mitigating hedging activities – and the Final Rule addresses the parameters of and possible conditions on these activities.

Under the Final Rule, larger banks and bank affiliates (based on total assets) engaged in proprietary trading permitted by the Final Rule will be subject to a comprehensive regime to ensure compliance with the Final Rule's prohibition on proprietary trading. In addition, the largest banks and bank affiliates (based on the amount of trading assets and liabilities) engaged in proprietary trading permitted by the Final Rule will be required to report a highly technical set of quantitative measures. Banking entities with only a "modest" level of trading activities will be subject to a much less comprehensive set of compliance requirements, and those entities participating in no covered activities will have no obligation under the Final Rule.

Our Volcker Rule User Guide discusses the requirements of the Final Rule in practical terms. [3] This alert focuses principally on the impact of the Final Rule for certain capital markets related activities.

The Final Rule applies to every "banking entity." A "banking entity" is essentially any insured depository institution or any foreign banking organization ("FBO") with U.S. banking operations or any affiliate of either. [4] In

[1] The authority for the Volcker Rule is set forth in section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010) ("Dodd-Frank" or the "Act") and codified in Section 13 of the Bank Holding Company Act (BHC Act), 12 U.S.C. § 1851. References to the "Volcker Rule" in this Guide generally refer to both Section 13 of the BHC Act as well as the Regulations promulgated as the Final Rule.
[2] The Final Rule was issued by the Agencies on December 10, 2013, but has not yet been published in the Federal Register. A copy of the rule can be found at at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a1.pdf. The Agencies also issued a Preamble on the same day which can be found at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a2.pdf. In this alert, we refer to the Preamble as the "Release."
The agencies that developed the Final Rule are the Federal Deposit Insurance Corporation ("FDIC"), the Federal Reserve Board ("FRB"), the Office of the Comptroller of the Currency ("OCC"), the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC").
[3] See our User Guide at http://www.mofo.com/files/Uploads/Images/131223-A-Users-Guide-to-The-Volcker-Rule.pdf.

the context of capital markets activities, it is worth noting that non-banking entities (such as broker-dealers or other financial intermediaries) not affiliated with banks or FBOs are not subject to the Final Rule. In the Release, the Agencies specifically note that "over time, non-banking entities may provide much of the liquidity that is lost by restrictions on banking entities' trading activities."[5] Non-banking entities may, therefore, wish to understand the types of activities that will be prohibited activities for banking entities.

Proprietary Trading[6]

The Volcker Rule prohibits a banking entity from engaging in proprietary trading. Proprietary trading is defined as engaging as principal for the trading account of the banking entity in the purchase or sale of a financial instrument. The Final Rule does not prohibit a banking entity from engaging in agency or riskless principal transactions. In order to determine whether a banking entity's activities are considered "proprietary trading," one must consider whether the transaction involves a "financial instrument," and whether the account for which the trade is placed satisfies the definition of "trading account." A "financial instrument" includes: a security (including an option on a security); a derivative (including an option on a derivative); and a contract of sale of a commodity for future delivery (or an option on the same). Specifically excluded from the definition of "financial instrument" are loans; a commodity that is not (i) an "excluded commodity"[7] (which would not include foreign exchange or currency), (ii) a derivative or (iii) a commodity future; and foreign exchange or currency.

Trading Account

The Final Rule provides a functional definition of "trading account," which means an account that satisfies any one of three criteria: a "purpose test," a "market risk capital rule test" or a "status test."

> *The Purpose Test.* A trading account includes any account used by a banking entity to buy or sell a financial instrument principally for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits or hedging a position resulting from any of the foregoing trading activities.
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> *Market Risk Capital Rule Test.* If the banking entity or any affiliate is an insured depository institution, bank holding company, or savings and loan holding company and calculates risk-based capital ratios under the market risk capital rule, a trading account includes accounts used to buy or sell one or more financial

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[4] A "banking entity" does not include a covered fund that is not itself a bank, a savings and loan holding company or an FBO. This is an important exception. A bank holding company that serves as the general partner of a fund would be deemed to control that fund and the fund is therefore an affiliate of the bank holding company. But for this exception, the "covered fund" would itself be a "banking entity" subject to the Volcker Rule.

[5] Release at 31.

[6] The Volcker Rule is 71 pages long and consists of Subparts A through D and Appendices A and B. Subpart A is titled "Authority and Definitions," and is not discussed directly here.

[7] An "excluded commodity" is as defined in Section 1a(19) of the Commodity Exchange Act, 7 U.S.C. 1a(19). "The term "excluded commodity" means—

(i) an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure;

(ii) any other rate, differential, index, or measure of economic or commercial risk, return, or value that is—

(I) not based in substantial part on the value of a narrow group of commodities not described in clause (i); or

(II) based solely on one or more commodities that have no cash market;

(iii) any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or

(iv) an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i)) that is—

(I) beyond the control of the parties to the relevant contract, agreement, or transaction; and

(II) associated with a financial, commercial, or economic consequence."

instruments that are both market risk capital rule covered positions and trading positions (or hedges of other market risk capital rule covered positions).

Status Test. If the banking entity is licensed or registered to engage in the business of a securities dealer, swap dealer or security-based swap dealer, a trading account includes any account used by a banking entity to purchase or sell financial instruments for any purpose to the extent the financial instruments are purchased or sold in connection with activities that require the banking entity to be so licensed or registered.

Given the "status test," the dealing activities of broker-dealers are generally captured by the prohibition unless these activities qualify for one of the enumerated exclusions discussed below. It is reasonable to anticipate that an investment bank may determine to limit its dealing activities in certain securities in light of the burdens imposed by the Final Rule.

Rebuttable Presumption

Trades are presumed to be for the trading account of a banking entity if the banking entity holds the position for fewer than sixty days, unless the banking entity can demonstrate that it did not make the trade for any of the purposes described in the preceding paragraphs. In the Release, the Agencies note that this rebuttable presumption is established "primarily to provide guidance to banking entities that are not subject to the market risk capital rules or are not covered dealers or swap entities and accordingly may not have experience evaluating short-term trading intent."[8] A banking entity can refute the presumption if it can demonstrate that it did not buy or sell the financial instrument principally for a short-term purpose. There is no implication that a position held for sixty days or longer is necessarily considered not to be held for short-term trading purposes.

Exclusions

As the definition of a trading account is broad, the Rule excludes the following types of trading from the definition of proprietary trading:

- Trades pursuant to purchase or reverse repurchase agreements;[9]
- Trades that arise under a transaction in which the banking entity lends or borrows securities temporarily under an agreement pursuant to which the lender retains the economic interest in the securities, and has the right to recall the loaned securities;
- Trades for the purpose of liquidity management in accordance with a documented liquidity management plan that meets specific requirements of the Final Rule;[10]

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[8] Release at 44.
[9] However, in the Release, the Agencies note that the collateral or position that is being financed by the repurchase or reverse repurchase agreement is not excluded and may involve proprietary trading.
[10] The liquidity management plan should:
(i) specifically contemplate and authorize the particular securities to be used for liquidity management purposes, the amount, types, and risks of these securities that are consistent with liquidity management, and the circumstances in which the securities may be used;
(ii) require that any transaction in securities under the plan be principally for the purpose of liquidity management and not for short-term price movements, resale, profits or arbitrage;
(iii) require that any securities purchased or sold for liquidity management purposes be highly liquid and limited to securities the risks of which the banking entity does not reasonably expect to give rise to appreciable profits or losses in the short term;

- Trades by a derivatives clearing organization or clearing agency;
- Any "excluded clearing activities"[11] by a banking entity that is a member of a clearing agency, a member of a derivatives clearing organization or a member of a designated financial market utility;
- Trades to satisfy an existing delivery obligation, including to prevent or close out a failure to deliver, in connection with delivery, clearing or settlement activity;
- Trades to satisfy an obligation in connection with a judicial, administrative, SRO or arbitration proceeding;
- Trades where the banking entity is acting solely as agent, broker or custodian;
- Trades through a deferred compensation, stock-bonus, profit-sharing or pension plan of the banking entity; and
- Trades made in the ordinary course of collecting a debt previously contracted ("DPC") in good faith, provided that the banking entity divests the financial instrument as soon as practicable.

Trades between affiliates are not specifically excluded from the definition of proprietary trading and therefore must rely on a stated exception from the prohibition.

Exemptions from the Prohibition on Proprietary Trading

The prohibition against proprietary trading does not apply to permitted underwriting activities, market making-related activities, risk-mitigating hedging activities and certain other trading activities. Significant comment was provided to the Agencies after the publication of the Proposed Rule regarding how best to distinguish these permitted activities from prohibited proprietary trading. The Final Rule enumerates detailed conditions for qualifying as permitted underwriting or market-making. The long commentary published with the Final Rule (referred to herein as the "Release") provides useful insights into the view of the Agencies regarding the distinctive features of these permitted activities. This alert is intended as a summary only.

In order to engage in a permitted activity, a banking entity must comply with three overall conditions:

- the banking entity must maintain an internal compliance program required by Subpart D to ensure that the banking entity complies with the conditions permitting the activity;
- the compensation arrangements of personnel involved in these activities must not be designed to reward or to create incentives to engage in prohibited proprietary trading; and
- the banking entity must be licensed or registered to engage in the permitted activity.

(iv) limit any securities and other instruments purchased or sold for liquidity management purposes to an amount consistent with the banking entity's near-term funding needs;
(v) include written policies and procedures, internal controls, analysis and independent testing to ensure that transactions in securities other than domestic or foreign government obligations are for the purpose of liquidity management; and
(vi) be consistent with the relevant Agency's supervisory requirements regarding liquidity management.

[11] Final Rule, §____.3(e)(7).

In addition, specific conditions apply in the case of each exemption.

Underwriting Activities

Trading in connection with underwriting activities are permitted only if the trading desk's[12] underwriting position is related to a "distribution" of securities for which the banking entity is acting as underwriter. [13] The underwriting position must be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and reasonable efforts are made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security.[14]

The Final Rule defines "underwriter" broadly to include a person who has agreed to purchase securities from an issuer or selling security holder for distribution, or engage in or manage a distribution of securities for or on behalf of the issuer or selling security holder, as well as a person who has agreed to participate or is participating in a distribution of securities on behalf of the issuer or selling security holder. As a result of this broad definition, an "underwriter" would include a selling group member or distributor. In addition, the Release provides a list of examples of the types of activities that may indicate that a banking entity is acting as an "underwriter." Similarly, the Release also identifies activities that may be conducted by an underwriter in connection with a distribution, such as stabilization activities, syndicate shorting, aftermarket short covering, holding an unsold allotment and helping an issuer mitigate its risk arising from the issuance of the securities in the distribution (such as entering into a call spread in connection with the issuance of convertible securities).[15] However, as we discuss below, the sale of an unsold allotment must comply with the other conditions of the underwriting exception. A position that results from these stabilization activities will be included as part of the trading desk's "underwriting position," and therefore will be subject to the requirement that the underwriter use reasonable efforts to sell or otherwise reduce its underwriting position within a reasonable time. As a result, in practice, an underwriter may choose to avoid certain types of securities offerings and certain activities related to offerings.

The Final Rule defines "distribution" to include offerings of securities made pursuant to a registration statement under the Securities Act of 1933 (the "1933 Act"), as well as offerings whether or not pursuant to the 1933 Act that involve special selling efforts and selling methods. The definition of "distribution" tracks in some respects the definition provided in Regulation M under the Securities Exchange Act of 1934, but excludes the need to consider the "magnitude" of the offering. As a result, distributions would include all offerings made pursuant to an effective registration statement. In the Release, the Agencies identify shelf offerings, bought deals, at-the-market offerings, offerings of asset-backed securities and initial public offerings as examples. In addition, the Release notes that "reverse inquiry" transactions would be included as "distributions." Other offerings that are not made pursuant to an effective registration statement would be included within the definition of a "distribution" provided that the offerings involve special selling efforts and selling methods. The Release discusses the types of activities that might constitute "special selling efforts." A "distribution" might also include private placements, Section 4(a)(1-1/2) offerings, Rule 144A offerings and commercial paper offerings. For many reasons, historically, banks chose to structure certain of their activities so as to avoid their being characterized as "distributions" for securities law purposes. Now, this may change as a result of the Final Rule.

Certain activities that an investment bank may undertake in connection with a distribution are specifically not part of the underwriting exception, although it may be possible to identify another appropriate exemption for

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[12] A "trading desk" is the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity. Final Rule, §____.3(e)(13).
[13] Final Rule, § ___.4(a).
[14] Final Rule, § ___.4(a).
[15] Release at 112.

which these activities would qualify. For example, in the Release, the Agencies note that "a trading desk would not be able to use the underwriting exemption to purchase a financial instrument from a customer to facilitate the customer's ability to buy securities in the distribution." This suggests that, for example, arranging for "pre-borrow" in a security may not be allowed, or facilitating a hedge in a related security in advance of or in connection with a distribution may not be allowed. Similarly, the Release notes that price discovery transactions also would not be covered by the underwriting exemption.[16] These transactions may qualify for the market-making exemption. In addition, the Release notes that "underwriting is distinct from product development." In this context, for example, the underwriter exemption is not available for accumulating securities in anticipation of a securitization or re-securitization or in connection with another structured finance transaction. It is not clear how this would be understood in the context of a structured product with an embedded derivative.

The amount and type of the securities in the underwriting position for a trade cannot exceed the reasonably expected near term demands of clients, customers or counterparties, and the trading desk must make reasonable efforts to reduce the underwriting position within a reasonable period. The terms "clients," "customers," and "counterparties" are defined as "market participants that may transact with the banking entity in connection with a particular distribution for which the banking entity is acting as underwriter." Another dealer would not be understood to be a client, customer or counterparty. In this context, it is not clear whether a distributor of securities may be considered a client or customer, or whether that would turn solely on a determination as to whether the distributor was a "banking entity."

In order to determine "near term demands," an underwriter must make reasonable judgments based on its experience with similar offerings, its knowledge of the market and market conditions, and its book-building experience. In the Release, the Agencies note that this requirement does not prevent an underwriter from retaining an unsold allotment that it was unable to sell to purchasers as part of the initial distribution of securities, provided that the underwriter had a reasonable expectation of buying interest and engaged in reasonable selling efforts.[17] However, the underwriter must make reasonable efforts to sell or otherwise reduce the underwriting position. The types of efforts that constitute "reasonable efforts to sell or otherwise reduce" the position will differ based on the liquidity, maturity and depth of the market for the security.

Banking entities may still find this requirement restrictive, and it may affect the willingness of investment banks to participate in certain types of transactions, such as bought deals, which are likelier to result in unsold allotments. Also, this requirement will limit the ability of an investment bank to retain an allocation of securities (such as securities for inventory or a "freezer account") for subsequent sale, especially if there was sufficient investor demand for the securities in the initial distribution.

As indicated above, the compensation policies of the banking entity must be designed not to reward or incentivize prohibited proprietary trading. The Agencies note that compensation "can take into account revenues resulting from movements in the price of securities that the banking entity underwrites to the extent that such revenues reflect the effectiveness with which personnel managed underwriting risk." The Proposed Rule had imposed a source of revenue requirement—that is, the underwriting activities of a banking entity would have been required to be designed in order "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 covered financial positions." This requirement was not included in the Final Rule given that the compliance and other provisions of the Final Rule are believed to be sufficient to mitigate unnecessary risk.

[16] Release at 113-114.
[17] Release at 124.

Also, as mentioned above, a banking entity must establish, implement, maintain and enforce an internal compliance program reasonably designed to ensure compliance with the requirements for relying on the underwriting exemption. We discuss the compliance program requirements in our User Guide.

Market Making-Related Activities

The prohibition on proprietary trading does not apply to purchases or sales of financial instruments by a banking entity made in connection with the banking entity's market making-related activities. In the Release, the Agencies explain that the market making exemption recognizes differences across markets and asset classes based on the liquidity, maturity, and depth of the market for a particular financial instrument. The Final Rule focuses on a trading desk's overall "financial exposure" and its "market maker inventory."[18] A significant portion of a trading desk's financial exposure should be comprised of financial instruments for which it makes a market.

Market making-related activities are permitted only if the relevant trading desk[19] "routinely stands ready" to purchase and sell one or more types of financial instruments related to its financial exposure and is "willing and available" to quote, purchase or sell 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.[20] In the Release, the Agencies provide a number of examples to illustrate how "routinely" standing ready may differ depending on market conditions and on the type of financial instrument.

> "For instance, a trading desk that is a market maker in liquid equity securities generally should engage in very regular or continuous quoting and trading activities on both sides of the market. In less liquid markets, a trading desk should engage in regular quoting activity across the relevant type(s) of financial instruments, although such quoting may be less frequent than in liquid equity markets. Consistent with the CFTC's and SEC's interpretation of market making in swaps and security-based swaps for purposes of the definitions of "swap dealer" and "security-based swap dealer," "routinely" in the swap market context means that the trading desk should stand ready to enter into swaps or security-based swaps at the request or demand of a counterparty more frequently than occasionally. The Agencies note that a trading desk may routinely stand ready to enter into derivatives on both sides of the market, or it may routinely stand ready to enter into derivatives on either side of the market and then enter into one or more offsetting positions in the derivatives market or another market, particularly in the case of relatively less liquid derivatives. While a trading desk may respond to requests to trade certain products, such as custom swaps, even if it does not normally quote in the particular product, the trading desk should hedge against the resulting exposure in accordance with its financial exposure and hedging limits. Further, the Agencies continue to recognize that market makers in highly illiquid markets may trade only intermittently or at the request of particular customers, which is sometimes referred to as trading by appointment. A trading desk's block positioning activity would also meet the terms of this requirement provided that, from time to time, the desk engages in block trades (i.e., trades of a large quantity or with a high dollar value) with customers.
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> Regardless of the liquidity, maturity, and depth of the market for a particular type of financial instrument, a trading desk should have a pattern of providing price indications on either side of the market and a pattern of trading with customers on each side of the market. In particular, in the case of relatively illiquid derivatives or

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[18] Release at 157-158. A trading desk's financial exposure will take into account a trading desk's positions in instruments for which it does not act as a market maker, but that are established as part of its market making-related activities, which includes risk mitigation and hedging. The Release provides a useful example of how a trading desk's market maker inventory and financial exposure will be analyzed. See Release at 205-206.

[19] *See* note 10 *supra*.

[20] Final Rule, § ___.4(b).

> structured instruments, it would not be sufficient to demonstrate that a trading desk on occasion creates a customized instrument or provides a price quote in response to a customer request. Instead, the trading desk would need to be able to demonstrate a pattern of taking these actions in response to demand from multiple customers with respect to both long and short risk exposures in identified types of instruments."

The amount, types and risks of the financial instruments in the trading desk's market-maker inventory must be designed not to exceed the reasonably expected near-term demands of clients, customers or counterparties, based on:

- the liquidity, maturity and depth of the market for the relevant types of financial instruments; and
- demonstrable analysis of historic 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.

The Final Rule establishes a rebuttable presumption that the trading desk of another banking entity with trading assets and liabilities exceeding $50 billion is not a "client, customer, or counterparty" for the purposes of considering whether trading with that desk is permitted market making. In the Release, the Agencies recognize, however, that allowing a trading desk to engage in customer-related interdealer trading is appropriate because it can help a trading desk appropriately manage its inventory and risk levels, and can effectively allow clients, customers or counterparties to access a larger pool of liquidity. The Release notes that:

> "The Agencies recognize that a trading desk, in anticipating and responding to customer needs, may engage in interdealer trading as part of its inventory management activities and that interdealer trading provides certain market benefits, such as more efficient matching of customer order flow, greater hedging options to reduce risk, and enhanced ability to accumulate or exit customer-related positions. The final rule does not prohibit a trading desk from using the market-making exemption to engage in interdealer trading that is consistent with and related to facilitating permissible trading with the trading desk's clients, customers, or counterparties."[21]

However, regulators will scrutinize interdealer trading to ensure it reflects market-making activities, and not impermissible proprietary trading.

The Agencies recognize that assessing near term customer demand may be more difficult in connection with certain more complex or less liquid securities, and also acknowledge that an assessment may take into account historical demand, market conditions and other factors, including forward-looking assessments.

In connection with certain complex products, the Agencies acknowledge that a market maker may engage in certain anticipatory trading. In the Release, the Agencies note that:

> "With respect to the creation and distribution of complex structured products, a trading desk may be able to use the market-making exemption to acquire some or all of the risk exposures associated with the product if the trading desk has evidence of customer demand for each of the significant risks associated with the product. To have evidence of customer demand under these circumstances, there must be prior express interest from customers in the specific risk exposures of the product. Without such express interest, a trading desk would not have sufficient information to support the required demonstrable analysis (*e.g.*, information about historical customer demand or other relevant factors). The Agencies are concerned that, absent express interest in each significant risk associated with the product, a trading desk could evade the market-making

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[21] Release at 252.

exemption by structuring a deal with certain risk exposures, or amounts of risk exposures, for which there is no customer demand and that would be retained in the trading desk's inventory, potentially for speculative purposes. Thus, a trading desk would not be engaged in permitted market making-related activity if, for example, it structured a product solely to acquire a desired exposure and not to respond to customer demand."[22]

A banking entity must establish, implement, maintain and enforce an internal compliance program that is reasonably designed to ensure that the banking entity complies with the requirements for relying on the market-making exemption. Among other things, the compliance program must identify how the banking entity hedges the risks associated with its market making activities. These market making related hedging activities must comply with the market making exemption and not with the hedging exemption. In documenting its compliance program, a banking entity should specify the risk-mitigating strategies that it intends to use for the financial instruments in which it is a market maker and the extent to which it will engage in anticipatory hedging. In the Release, the Agencies note that a trading desk "may hedge against specific positions promised to customers, such as volume-weighted average price ("VWAP") orders or large block trades, to facilitate the customer trade."[23] This would seem to permit various issuer related equity derivatives transactions, like accelerated share repurchases. We discuss the other elements of the compliance program in our User Guide.

Permitted Risk-Mitigating Hedging Activities

The prohibition on proprietary trading does not apply to certain risk-mitigating hedging activities. Section ___.5(a) of the Final Rule permits, subject to numerous conditions, hedging activities that are "in connection with and related to individual or aggregated positions, contracts or other holdings" and "designed to reduce the specific risks to the banking entity" that are "related to such positions, contracts or other holdings." In order to distinguish between these risk-mitigating hedging activities and impermissible proprietary trading, the Final Rule requires that a banking entity establish a compliance program as outlined in Subpart D, which we discuss in the User Guide, establish enhanced documentation requirements in connection with certain risk-mitigating hedging activity, and establish compensation policies for those performing the risk-mitigating hedging activities that do not reward prohibited proprietary trading.

In conducting risk-mitigating hedging activities, the banking entity must act in accordance with its written policies and procedures. The banking entity should determine at the inception of its trading that the risk-mitigating hedging activity should be demonstrably risk reducing or mitigating. The Agencies note that "at the inception of the hedging activity, the risk-reducing hedging activity [must not] give rise to significant new or additional risk that is not itself contemporaneously hedged."[24] The banking entity must conduct analysis and independent testing to ensure that the positions, techniques, and strategies used for hedging are reasonably designed to reduce or otherwise mitigate the risk being hedged.[25] The Release notes that the Final Rule does not prohibit dynamic hedging or anticipatory hedging. However, the Release also notes that a banking entity must continuously monitor its activities to ensure that these are risk reducing. The Release also makes clear that this exemption is not intended to address a banking entity's hedging activities with respect to "generalized risks that a trading desk or combination of desks, or the banking entity as a whole, believe exists based on non-position-specific modelling or other considerations."[26] The Release provides a number of examples of the types of "generalized" risks that hedging activity cannot be designed to reduce.

[22] Release at 258.
[23] Release at 271.
[24] Release at 349.
[25] Release at 350.
[26] Release at 346.

The Final Rule imposes additional documentation requirements with respect to risk-mitigating hedging activities established by a trading desk other than the desk responsible for the underlying positions and with respect to hedges of aggregated positions across trading desks.

Other Permitted Proprietary Trading Activities

The prohibition on proprietary trading does not apply to the following:

- trading in U.S. government or government agency securities;
- trading in municipal bonds;
- trading by a foreign bank subsidiary of a U.S. banking entity of debt of a foreign government (or of any agency or political subdivision of that foreign government) issued by the foreign country in which the foreign bank affiliate is organized; and
- trading by a banking entity that is a regulated insurance company (including a foreign insurance company), whether for the insurance company's general account or for a separate account.

The prohibition on proprietary trading is a prohibition on the banking entity acting as principal. Thus, as discussed above, trades by a banking entity acting solely as agent, broker or custodian are not prohibited. In addition, the prohibition does not extend to trades by the banking entity as trustee or in a similar fiduciary capacity for a customer, so long as the transaction is conducted for the account of, or on behalf of the customer and the banking entity (or an affiliate) does not have or retain a beneficial ownership of the financial instruments. A banking entity also can conduct riskless principal activities so long as these are "customer-driven and may not expose the banking entity to gains (or losses) on the value of the traded instruments as principal."[27]

Exemptions for FBOs

The Final Rule establishes an exemption for proprietary trading by an FBO to the extent the trading is conducted solely outside the United States. In addition, U.S. affiliates of FBOs are permitted to engage in proprietary trading of debt of the foreign country (or its agencies or political subdivisions) under which the FBO is organized. These two exemptions are discussed at greater length in our Client Alert available at http://www.mofo.com/files/Uploads/Images/131211-Volcker-Rule.pdf. Although ultimately any final assessment will depend on the distinct facts and circumstances, for many FBOs with relatively limited activities in the United States, the most practical outcome may be to review their trading activities and structure these in order to satisfy the exemption for trading conducted solely outside the United States rather than to seek to comply with the other exemptions that require establishing burdensome compliance policies and procedures.

Prudential Backstops

The permitted proprietary trading activities referenced above are not permissible under the Final Rule if (i) they would involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties; (ii) they would result in a material exposure by the banking entity to a high-risk asset[28] or a high-

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[27] Release at 397.

[28] An asset 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. Final Rule, § ____.7(c)(1).

risk trading strategy;[29] or (iii) they pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

A material conflict of interest is deemed to exist if the banking entity engages in transactions 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 transactions, and prior to engaging in such transactions, the banking entity has not made appropriate disclosures to address the conflict of interest or, in appropriate circumstances, established information barriers memorialized in written policies and procedures, such as physical separation of personnel or functions or other measures designed to prevent such conflict of interest.

The Release notes that "clear and meaningful information" about the conflict of interest should be provided to the client in advance of the transaction. The Release makes clear that generic disclosures would not be considered sufficient, and that the disclosures must be reasonably detailed. The Release notes that "[c]oncerns regarding conflicts of interest are likely to be elevated when a transaction is complex, highly structured or opaque, involves illiquid or hard-to-value instruments or assets, requires the coordination of multiple internal groups (such as multiple trading desks or affiliated entities) or involves a significant asymmetry of information or transactional data among participants."[30] This guidance is consistent with the guidance of the SEC and of FINRA on conflicts of interest disclosures. However, the Release goes further to note that the "Agencies do not believe that consent or waivers alone are sufficient to address material conflicts of interest, and continue to believe that any banking entity using disclosure to address a conflict of interest should be required to provide any client, customer, or counterparty with whom the banking entity has a conflict with the opportunity to negate or substantially mitigate the materially adverse effect of the conflict on the client, customer, or counterparty."[31] It is not clear what this would entail.

The requirements relating to information walls would not seem to pose any new issues for banking entities that are already subject to extensive requirements relating to the handling of information.

As noted above, under the Final Rule, a banking entity is required to ensure that it monitors its permitted activities to determine whether it would be exposed to high-risk assets or trading strategies. In the Release, commenting on the definitions of "high-risk assets and trading strategies," the Agencies note that they believe "it is appropriate to include a broad definition of these terms that accounts for different facts and circumstances that may impact whether a particular asset or trading strategy is high-risk with respect to a banking entity."[32]

As we noted in our User Guide, failure to comply with these prudential backstops can take away the availability of what otherwise appears to be a clearly available trading exemption. This is worrisome in that there are no clear guidelines regarding the measures a banking entity is required to take with respect to any given activity to ensure compliance. The types of activities or strategies that may be deemed "high-risk" will be determined in hindsight.

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[29] 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. Final Rule, § ____.7(c)(2).
[30] Release at 445.
[31] Release at 449.
[32] Release at 461.

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The new regulatory framework in the United States and Europe has introduced a series of new terms. We have compiled a brief glossary intended to serve as a helpful summary of frequently used terms. To download a copy of the glossary, click here.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.