

# IFLR

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Morrison &amp; Foerster

### The Volcker Rule

Market participants are still poring through the final regulations under section 619 of the Dodd-Frank Act, known as the Volcker Rule. 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. Given the breadth of the activities covered by the Volcker Rule, most financial institutions will be affected. 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. Trades are presumed to be for the trading account of a banking entity if the position is held for fewer than sixty days, unless the banking entity can demonstrate otherwise. Certain trading activity is expressly permitted, such as in connection with underwriting activities, market making-related activities, and risk-mitigating hedging activities. However, the conditions for reliance on these exclusions are complex. In order to engage in a permitted activity, a banking entity must maintain an internal compliance programme; the compensation arrangements of personnel involved in the activity 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.

Trading in connection with underwriting activities is permitted only if the trading desk's underwriting position is related to a distribution of securities for which the banking entity is acting as underwriter. The prohibition on proprietary trading does not apply to purchases or sales of financial instruments by a banking entity made in connection with that entity's market making-related activities. 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' are permitted. In order to distinguish between these permitted activities and impermissible proprietary trading, the rule requires banking entities to establish comprehensive compliance policies, procedures, and rigorous calculations and documentation. Certain activities that occur solely outside of the US are excluded from the scope of the rule. Although it is still too early to assess the full impact of the rule on capital markets activities in the US, it is fair to assume that certain foreign banking entities with limited operations in the country may determine to restructure their US business and pare back the scope of their activities. For US banking entities, it is reasonable to anticipate that more business may be conducted on an agency or riskless principal basis, and that market making in certain more illiquid securities may be negatively affected. Given that non-bank broker-dealers are not subject to the rule, certain activities may shift to these entities. Over time, the effects are likely to be more far-reaching than these observations suggest.

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