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IMPACT OF THE VOLCKER RULE ON DERIVATIVES MARKETS

The Volcker Rule's prohibition on proprietary trading by banking entities applies broadly to trading activity in derivatives. The authors discuss the key definitions that determine the scope of the rule, and the exemptions for riskless principal and market-making transactions. They find that the high costs of compliance may result in regional and smaller banks withdrawing from permitted derivatives activity, which may decrease competition and increase costs for market participants.

By Julian E. Hammar and Oliver I. Ireland *

Banking entities that were swap dealers prior to the enactment of the Dodd-Frank Act[1] enjoyed a relatively successful business model. In response to demand from a customer, a swap dealing banking entity would enter into a swap with that customer, and then hedge the risk in the interdealer market with the same or similar type of swap, often profiting from spreads between the two positions. With limited regulation and increasing customer demand, derivatives trading increased, and banking entities offered a steady supply of new derivatives products and services.

With the financial crisis in 2008 and the subsequent regulatory response, that model has been significantly affected. Higher capital requirements, the leverage ratio, clearing and exchange-trading requirements, and registration requirements with respect to swaps have significantly chipped away at the business model. In addition to these regulatory requirements comes the prohibition on proprietary trading contained in section 619 of the Dodd-Frank Act, commonly known as the "Volcker Rule."[2] Although ostensibly adopted to

1 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2 The Volcker Rule is now embodied as section 13 of the Bank Holding Company Act of 1956, as amended ("BHCA"), 12 U.S.C. 1851.

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prohibit speculative activity in risky short-term investments by banks using funds backed by federal deposit insurance, in practice the Volcker Rule has much wider impact — including with respect to the non-speculative activity characteristic of the swaps business model described above. This wider impact is because the Volcker Rule's prohibition on proprietary trading applies broadly to trading activity in derivatives (including swaps) if the banking entity is licensed or registered, or required to be licensed or registered, as a swap dealer or security-based swap dealer, to the extent the derivative is purchased or sold in connection with the activities that require the banking entity to be licensed or registered as such. While the Volcker Rule provides for a number of exemptions to the proprietary trading prohibition — the most applicable exemption for customer-driven swaps entered into by banking entities being the market-making exemption — the market-making exemption includes stringent requirements, a sophisticated compliance program, and reporting metrics for most banking entities, as well as prudential safeguards. As a result, the attractiveness of offering derivatives for banking entities, which may already be in decline as a result of other Dodd-Frank Act requirements, will likely decline even more due to the requirements of the Volcker Rule.

In this article, we look at some of the potential impacts of the Volcker Rule on derivatives markets. In general, we believe it is likely that regulatory costs of the Volcker Rule, among other regulations, could lead to the withdrawal of many regional and smaller banking entities from the derivatives market (or to the restructuring of their activities as brokered trades), and result in a greater concentration of derivatives activities in a smaller number of very large banks, which will pass on these costs to their customers.

BROAD APPLICABILITY OF THE PROPRIETARY TRADING PROHIBITION

The impact of the Volcker Rule on banking entities' derivatives activities may largely be felt due to the sweeping applicability of the proprietary trading prohibition to derivatives contained in the regulations implementing the Volcker Rule. These regulations were promulgated by the Board of Governors of the Federal Reserve System ("FRB"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission ("CFTC") (collectively, the "Volcker Agencies") in January 2014.[3] Under the regulations, a banking entity may not "purchase" or "sell" a "financial instrument" as principal for its own "trading account" (a term used to denote the transactions that are subject to the ban on proprietary trading),[4] as these terms are defined in the regulations. The broad definitions of these terms, as discussed below, will capture a significant portion of banking entities' derivatives activity within the rule's ambit.

Definition of the Term "Financial Instrument"

The term financial instrument includes a security, a derivative, and a contract of sale of a commodity for future delivery, and options on each of the foregoing.[5] The term "derivative" is defined expansively to include:

- swaps and security-based swaps as defined in the Commodity Exchange Act ("CEA") and the Securities Exchange Act of 1934 ("Exchange Act");[6]
- forward contracts in non-financial commodities that otherwise are excluded from the swap definition in the CEA;
- foreign exchange forwards ("FX Forwards") and foreign exchange swaps ("FX Swaps") as defined in

[3] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5,536 (Jan. 31, 2014). The CFTC separately issued an identical version of the Volcker Rule, 79 Fed. Reg. 5,808 (Jan. 31, 2014). Citations in this article are to the regulations as promulgated by the banking agencies.

[4] 79 Fed. Reg. at 5,548 n. 124.

[5] Volcker Rule ___.3(c)(1). A financial instrument does not include a loan, certain commodities, foreign exchange, or currency. Volcker Rule __.3(c)(2).

[6] 7 U.S.C. § 1a(47) (definition of the term "swap"); 15 U.S.C. § 78c(a)(68) (definition of the term "security-based swap").

the CEA that were exempted by the Secretary of the Treasury from most requirements under the CEA;[7]

- certain retail transactions in foreign currency and other commodities described in the CEA;[8] and
- leverage contracts[9] regulated under the CEA.[10]

Thus, while the definition captures instruments traditionally considered to be derivatives (e.g., futures, swaps and options thereon), even instruments that are not subject to regulation under the CEA and typically are not considered derivatives, such as forward contracts in non-financial commodities, are included in the definition of the term derivative and thus are subject to the Volcker Rule's proprietary trading prohibition. Similarly, instruments that generally are exempt from most CEA regulations, such as FX Forwards and FX Swaps, are likewise included in the definition and subject to the prohibition. The breadth of the financial instrument definition thus ensures that the Volcker Rule will impact a wide range of instruments.

Definition of the Term "Trading Account"

A banking entity will be deemed to be engaging in purchases or sales of financial instruments, including derivatives, for its own trading account in each of the following cases:

- The purchase or sale is for short-term resale or to benefit from short-term price movements or arbitrage profits (and related hedges) (referred to as the "Purpose Test");[11]
- If the banking entity or an affiliate is subject to U.S. market risk capital rules, the account is used to purchase or sell financial instruments that are both market risk capital rule covered positions and trading positions, or hedges of other market risk capital rule covered positions (referred to as the "Market Risk Capital Rule Test");[12] or
- The purchase or sale is (A) by a banking entity that is a securities dealer, swap dealer, or security-based swap dealer, or by an entity required to be licensed as such, to the extent that the trade is of a kind that would trigger the registration requirement or (B) the banking entity is engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, to the extent the financial instrument is traded in connection with the activities of such business (referred to as the "Status Test").[13]

A rebuttable presumption is provided under which purchases or sales are presumed to be for the trading account of a banking entity if the banking entity holds the position for fewer than 60 days or substantially transfers the risk of the financial instrument within 60 days of the purchase (or sale), unless the banking entity can demonstrate that it did not make the trade principally for a short-term purpose.[14] There is no reverse

[7] Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act, 77 Fed. Reg. 69,694 (Nov. 20, 2012) ("Treasury Determination"). The term FX Forward is defined in the CEA to mean a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange. 7 U.S.C. § 1a(24). The term FX Swap means a transaction that solely involves (A) an exchange of two different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange and (B) a reverse exchange of the two currencies described in (A) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange. 7 U.S.C. § 1a(25).

[8] 7 U.S.C. §§ 2(c)(2)(C)(i) and 2(c)(2)(D)(i).

[9] 7 U.S.C. § 19.

[10] Volcker Rule __.2(h)(definition of the term "derivative"). The rule provides that the definition of the term derivative does not include certain consumer, commercial, or other transactions that the CFTC and SEC jointly have further defined as not included in the swap or security-based swap definitions, and any identified banking product as defined in Section 402(b) of the Legal Certainty for Bank Products Act of 2000 ("LCBPA") that is subject to section 403(a) of that Act. Volcker Rule __.2(h)(2). In August 2012, the CFTC and SEC issued regulations and interpretations further defining the term "swap" and "security-based swap." 77 Fed. Reg. 48,207 (Aug. 13, 2012), which includes interpretations excluding a number of consumer, commercial, and other transactions from the swap and security-based swap definitions, which fall within this exclusion under the Volcker Rule. Section 402(b) of the LCBPA defines identified banking product as having the same meaning as paragraphs (1) through (5) of section 206(a) of the Gramm-Leach-Bliley Act, which include traditional banking products such as deposit accounts, savings account, certificates of deposit, banker's acceptances, and letters of credit. 7 U.S.C. § 27(b). Neither of these exclusions encompass transactions that generally would be considered derivatives.

[11] Volcker Rule __.3(b)(1)(i).

[12] Volcker Rule __.3(b)(1)(ii).

[13] Volcker Rule __.3(b)(1)(iii).

[14] Volcker Rule __.3(b)(2).

presumption that a financial instrument held for longer than 60 days is not for short-term trading purposes.

Scope of the "Status Test"

Returning to our original business model for banking entities, it is likely that entering into many types of swaps in response to a request from the customer and then hedging that risk by entering into the same or a substantially similar type of swap in the interdealer market will generally require registration with the CFTC as a swap dealer. Under the Dodd-Frank Act, the term "swap dealer" is defined to mean any person who enters into swaps in an amount exceeding a *de minimis* threshold and:

- holds itself out as a dealer in swaps;
- makes a market in swaps;
- regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
- engages in any activity causing itself to be commonly known in the trade as a dealer or market-maker in swaps.[15]

The CFTC and the SEC, in regulations further defining the terms "swap dealer" and "security-based swap dealer," explained that market-making activity includes routinely standing ready to enter into swaps as principal at the request or demand of a counterparty, where "routinely" means that the person does so more frequently than occasionally.[16]

This definition generally appears to capture the trading activity described in the business model for most types of swaps, requiring banking entities to register as swap dealers.[17] Such swaps would be subject to the Status Test and the proprietary trading prohibition in the Volcker Rule, unless an exemption or exclusion in the Rule applies. For banking entities that are (or are required to be) licensed or registered as swap dealers, the Status Test in practice will likely sweep in more trading activity under the proprietary trading prohibition than the regulation expressly covers. While the Status Test requires that a banking entity include purchases or sales of financial instruments for any purpose "to the extent the instrument is purchased or sold in connection with the activities that require the banking entity to be licensed or registered" as a swap dealer, banking entities generally have not undertaken an analysis as to which swaps are in connection with their swap dealing requiring registration.[18] Instead, banking entities have relied upon the more objective *de minimis* threshold from swap dealer registration provided for in the CFTC's and SEC's regulations, pursuant to which, if a person enters into swaps below $8 billion notional amount over a rolling 12-month period, registration is not required.[19] If a banking entity enters into swaps in a dealing capacity above this threshold, registration is

[15] 7 U.S.C. § 1a(49)(A). A similar definition applies to security-based swap dealers, 15 U.S.C. § 78c(a)(71).

[16] Further Definition of "Swap Dealer," "Security-based Swap Dealer," "Major Swap Participant," "Major Security-based Swap Participant," and "Eligible Contract Participant," 77 Fed. Reg. 30,596, 30,609 (May 23, 2012) ("Entity Definitions Release"). There is no requirement that a person do so "continuously," however. *Id.*

[17] Most banking entities that engage in swaps activity enter into interest rate swaps, which are subject to the jurisdiction of the CFTC and would require registration as swap dealers. The CFTC also has jurisdiction over swaps based on currencies (subject to the exemption for FX Swaps and FX Forwards), energy commodities, agricultural commodities, metals, and

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broad-based security indices. The SEC has jurisdiction over security-based swaps, which are swaps based on a single security or loan, a narrow-based security index, and certain events related to issuers of securities. Activity involving security-based swaps would require registration as a security-based swap dealer. According to OCC data, approximately 78% of total derivatives notional amounts were in interest rate swaps. OCC's Quarterly Report on Bank Trading and Derivatives Activities First Quarter 2015, *available at* http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq115.pdf. As of this writing, 104 banking entities have registered as swap dealers with the CFTC. http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer.

[18] Commenters to the Volcker Rule noted that they do not currently analyze whether a particular activity would require dealer registration. 79 Fed. Reg. at 5,549.

[19] 17 C.F.R. § 1.3(ggg)(4)(*de minimis* exception from swap dealer registration). A similar *de minimis* threshold applies to security-based swap dealer registration, 17 C.F.R. § 240.3a71-2 (*de minimis* exception from security-based swap dealer registration). Notably, the *de minimis* threshold of $8 billion is a phase-in level, and unless the CFTC and SEC take action, is set to drop automatically from $8 billion to $3 billion in 2017. 17 C.F.R. § 1.3(ggg)(4)(i) and 17 C.F.R. § 240.3a71-2(a)(1). This drop would subject a greater number of banking entities swap dealer registration, and in turn the Status Test under the Volcker Rule, further widening its impact.

required, and subjects such swaps activity to the proprietary trading prohibition.

Except for banking entities that may be on the verge of surpassing the *de minimis* threshold, banking entities with swaps activities substantially greater than $8 billion notional amount have registered as swap dealers without undertaking an analysis of which swap transactions constituted dealing activity requiring them to register. This is because such an analysis likely would be expensive and in many cases inconclusive, since the CFTC and SEC generally established subjective criteria for determining what constitutes "dealing activity."[20] Once registered as a swap dealer, the CFTC and SEC's regulations apply to all of a swap dealer's activity, not just to swaps activity requiring registration, so there is no reason to conduct such an analysis after registration is required.[21] A likely outcome is that banking entities that are swap dealers will consider most of their derivatives transactions as subject to the Status Test, not just those that required them to register. Foreign banking entities that engage in the business of swap dealing face a similar challenge,[22] although they may be able to rely upon the "solely outside the United States" exemption for much of their trading activity.[23]

Definitions and the Rebuttable Presumption for Derivatives

Banking entities that conduct only a *de minimis* amount of swap dealing activity in accordance with the business model would not be subject to the Status Test because they would not be required to register as swap dealers. Nor would banking entities that engage in such activity solely with respect to FX Swaps and FX Forwards be subject to the Status Test because of the Treasury Secretary's determination to exempt these products from most provisions of the CEA.[24] Nonetheless, it is likely that their activity still would be captured within the Trading Account (and subject to the proprietary trading prohibition) under the Purpose Test.

While the Purpose Test by itself would not seem to encompass derivatives that have tenors of greater than 60 days, which includes most derivatives other than those involving foreign exchange, its scope is much greater than would first appear. The broad definitions of the terms "purchase" and "sale," and the rebuttable presumption in the regulations as applied to derivatives, greatly expands the scope of the Purpose Test. Under these definitions, a derivative is deemed to be purchased or sold by a banking entity when it is executed (e.g., a banking entity writes an interest rate swap); terminated (prior to its scheduled maturity date); assigned; exchanged; or otherwise transferred, or the rights under the derivative are extinguished, as the context may

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[20] Certain exclusions are more objectively applied, such as the exclusion for swaps entered into with a customer in connection with originating a loan with that customer, 17 C.F.R. § 1.3(ggg)(5), inter-affiliate swaps, 17 C.F.R. § 1.3(ggg)(6)(i), or swaps entered into to hedge physical positions, 17 C.F.R. § 1.3(ggg)(6)(iii). However, as a general matter, the tests for determining whether swap dealer or security-based swap dealer registration is required are subjective.

[21] 17 C.F.R. § 1.3(ggg)(3)(stating that "[a] person who is a swap dealer shall be deemed to be a swap dealer with respect to each swap it enters into, regardless of the category of the swap or the person's activities in connection with the swap."); Entity Definitions Release at 30,645. While a person may apply to the CFTC for a "limited purpose designation" as a swap dealer, pursuant to which it may be considered a swap dealer with respect to specified categories of swaps or specified activities in connection with swaps, the default presumption is for designation as a swap dealer with respect to all swaps categories and activities.

[22] Under the Status Test, if a banking entity is engaged outside the United States in the business of a dealer, swap dealer, or security-based swap dealer, the banking entity will be deemed to be engaged in proprietary trading to the extent the trade is made in connection with such business. The terms "dealer," "swap dealer," and "security-based swap dealer" refer to the definitions contained in the relevant U.S. laws. The federal regulatory agencies rejected a request by representatives of foreign banks that the Volcker Rule use the relevant foreign regulators' counterparts for these terms with respect to trades outside the United States. 79 Fed. Reg. at 5,549 n. 141.

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Accordingly, a foreign banking organization or its non-U.S. affiliate that engages in trading of financial instruments outside the United States will need to apply the U.S. definitions and related interpretations to its activities to determine whether it is engaged in proprietary trading under the Volcker Rule. These definitions are unlikely to conform with those used outside the United States by home-country regulators, which may make it very difficult to determine whether any particular trade is a proprietary trade under the Status Test. *See generally* Henry M. Fields and Barbara R. Mendelson, *The Volcker Rule's Impact on Foreign Banking Organizations*, The Review of Banking & Financial Services, Vol. 30, no. 8 (Aug. 2014).

[23] Volcker Rule __.6(e)(providing for an exemption for foreign banking entities for proprietary trading activity to the extent it is conducted "solely outside the United States").

[24] Treasury Determination, *supra* note 7.

require.[25] Further, the Volcker Rule preamble explains that "basis trades," in which a banking entity buys one instrument and sells a substantially similar instrument (or otherwise transfers the first instrument's risk) are subject to the rebuttable presumption, which applies not only when an instrument is held for 60 days, but also when the risk is substantially transferred within 60 days.[26]

Thus, purchases or sales of derivatives include not just execution of a derivatives transaction, but a number of other activities, and likely will include any related transactions that shift, offset, or otherwise alter the risk in a derivative transaction, which, if conducted within 60 days, are subject to the rebuttable presumption. This means that banking entities who engage in a *de minimis* level of dealing activity, or who engage in FX Swaps or FX Forwards, will have most of their transactions subject to the Purpose Test, except for long-dated instruments of greater than 60 days that are held to maturity and the risk of which is not otherwise transferred.[27] In the case of FX Forwards and FX Swaps, where the bulk of liquidity is in instruments with short-dated tenors (e.g., less than 60 days), the coverage of the Purpose Test likely is even greater, since holding to maturity (without transferring the risk) in many cases would still constitute trading for short-term profit under the Purpose Test.

VOLCKER RULE EXEMPTIONS FOR DERIVATIVES

While sweeping in the scope of its applicability to derivatives, the Volcker Rule does provide for exemptions that may be applicable to banks' swap dealing business model: the riskless principal exemption and the market-making exemption.[28] An exemption also is provided for purchases or sales of financial instruments where the banking entity is acting solely as agent, broker, or custodian.[29] However, under the traditional swap dealing business model, banks would enter into derivatives as principal, making this exclusion unavailable (although for many banking entities, this may be a relatively low-cost alternative to the other exemptions described below). The riskless principal exemption, while less onerous in terms of regulatory requirements than the market-making exemption, has ambiguity associated with it (as applied to derivatives) that may encourage banking entities to conduct their activities under the market-making exemption, which, as discussed below, has higher compliance obligations and costs.

Riskless Principal Transactions

The exemption for riskless principal transactions permits a banking entity to enter into a trade as principal for a financial instrument, if, after receiving a purchase or sell order from a customer, it enters into a contemporaneous offsetting financial instrument as principal with a third party.[30] Any activity must be "customer-driven" and may not expose the banking entity to gains (or losses) on the value of the traded financial instruments as principal.[31] One commenter on the proposed Volcker Rule regulations requested that the Volcker Agencies clarify how the riskless principal exemption would apply to transactions in derivatives, including hedged derivative transactions executed at the request of a customer.[32] The preamble of the Volcker

[25] Volcker Rule__.2(u) (definition of the term purchase) and ___.2(x) (definition of the term sale).

[26] 79 Fed. Reg. at 5,550 (stating that "the final rule clarifies that basis trades, in which a banking entity buys one instrument and sells a substantially similar instrument (or otherwise transfers the first instrument's risk), are subject to the rebuttable presumption) and Volcker Rule __.3(b)(2) (rebuttable presumption applies if the banking entity holds the financial instrument for fewer than 60 days *or substantially transfers the risk of the financial instrument within 60 days of the purchase (or sale)*) (emphasis added).

[27] A potential unintended consequence of this exception is that banking entities that may wish to avoid regulatory costs associated with compliance with the Volcker exemptions may be incentivized to hold swaps to maturity, even where that may not be optimal in terms of the safety and soundness of the banking entity, where shifting the risk might be more salubrious.

[28] The Volcker Rule also includes an exemption for risk-mitigating hedging activities. Volcker Rule __.5. However, this exemption would not apply to the business model of a bank entering into a swap with a customer and then hedging its risk in the interdealer market — such activity (including the hedging) would be encompassed by the riskless principal or market-making exemptions. To the extent a banking entity undertakes hedging activities for its own portfolio subject to this exemption, the exemption has similar requirements to the market-making exemption, including a compliance program, reporting metrics, and prudential backstops, that likely will curtail regional and smaller banks' hedging activity involving derivatives in a similar manner to their market-making activities, as discussed below.

[29] Volcker Rule ___.3(d)(7).

[30] Volcker Rule __.6(c).

[31] 79 Fed. Reg. at 5,649.

[32] 79 Fed. Reg. at 5,648 and n. 1,429.

Rule release does not expressly address this issue, however. Instead, the preamble explains that the term "riskless principal" is derived from the permitted use of riskless principal transactions in the FRB's Regulation Y.[33] In Regulation Y, the permission to engage in riskless principal transactions is limited to trades in securities.[34] The Volcker Agencies stated that "they intend to determine whether a banking entity acts as riskless principal in accordance with and subject to the requirements of [the standards in Regulation Y]."[35]

At the same time, however, the text of the regulation says that the riskless principal exemption applies to "financial instruments," which is not limited to securities, but includes derivatives. And in other parts of the regulation, the Volcker Agencies used the word "securities" when discussing the applicability of an exclusion or exemption. For example, the exclusion in the regulations for liquidity management activities expressly applies to securities only, not to financial instruments.[36] Thus, the agencies clearly knew how to limit the regulation's language to securities (and not financial instruments) where they deemed it appropriate.

Even if the riskless principal exemption were permitted for derivatives, however, the exemption appears to require that the instruments would have to be exactly identical, which likely would be uneconomic in many situations. The riskless principal exemption also remains subject to the compliance program requirement and the so-called prudential backstops provided for in the Volcker Rule discussed below in connection with the market-making exemption, which is also subject to these requirements.[37] Such requirements are not imposed for agency or brokered trades, which, as mentioned above, are excluded from the proprietary trading prohibition and may make them a more attractive alternative to riskless principal transactions (or the market-making exemption) that are subject to these requirements.

Market-making Exemption

As applied to derivatives used in connection with the banks' traditional swaps trading business model, the most relevant exemption under the Volcker Rule is the market-making exemption. Under the market-making exemption, a banking entity's trading desk that establishes and manages the financial exposure must "routinely" stand ready to purchase and sell one or more types of financial instruments related to its financial exposure. Further, the trading desk must be willing and available to quote, purchase, sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts, and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of market for the relevant type of financial instruments.[38]

In the Volcker Rule release, the Volcker Agencies provide a number of examples to illustrate how "routinely" standing ready may differ depending upon market conditions and the type of financial instrument. For derivatives, the Volcker Agencies stated:

> 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-

33 *Id.*

34 *Id.* 12 C.F.R. § 225.28(b)(7)(ii). The Volcker Agencies also cited an SEC regulation, 17 C.F.R. § 240.3a5-1b, and an OCC interpretive letter No. 626 (July 7, 1993), both of which discuss riskless principal in the context of securities only.

35 79 Fed. Reg. at 5,649.

36 Volcker Rule ___.3(d)(3) (providing that the liquidity management exclusion applies to "any purchase or sale *of a security* by a banking entity for the purpose of liquidity management in accordance with a documented liquidity management plan")(emphasis added).

37 Volcker Rule __.20 (compliance program) and __.7 (prudential backstops).

38 Volcker Rule ___.4(b)(2)(i).

> 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.[39]

Regardless of the liquidity, maturity, and depth of the market for a particular type of financial instrument, the Volcker Agencies have indicated that 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.[40]

In addition, the market-making exemption requires that the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near-term demands of clients, customers, or counterparties, based on (i) the liquidity, maturity, and depth of market for the type of financial instrument and (ii) 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.[41]

The Volcker 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.[42] Of some importance to the traditional bank business model, where the customer-driven transaction is hedged in the interdealer market, the Volcker Agencies recognize in the release 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.[43] However, the Volcker Agencies stated that they will scrutinize interdealer trading to ensure it reflects market-making activities, not impermissible proprietary trading.

Where a banking entity responds to customer requests to enter into derivatives, such activity would be considered market-making under the Volcker Rule. Hedging the banking entity's risk by entering into a transaction in the interdealer market (as it would do under the traditional business model) generally would be conducted under the market-making exemption, not the separate risk-mitigating hedging exemption.[44] The banking entity would have to engage in this activity "more frequently than occasionally" and on both sides of the market (e.g., purchases as well as sales). In addition, it would have to do so in response to reasonably expected near-term demand of customers, measured in accordance with the regulation. While a banking entity may hedge its risk in the interdealer market, it would need to carefully document this activity, since, as mentioned above, the Volcker Agencies intend to scrutinize this activity carefully.

Provided the above requirements are satisfied, the banking entity also must establish a compliance program, report metrics, and comply with the prudential backstops, as described below.

Market-making Exemption Requirements

Compliance Program. The Volcker Rule requires banking entities that are engaged in market-making (and other permitted activities) to establish and maintain a compliance program that is reasonably designed to ensure and monitor their compliance with the Volcker Rule, and is tailored to the size and complexity of the banking entity and its covered trading activities.

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[39] 79 Fed. Reg. at 5,595.

[40] *Id.* at 5,596.

[41] Volcker Rule __.4(b)(2)(ii).

[42] Volcker Rule __.4(b)(3)(i).

[43] 79 Fed. Reg. at 5,609. In this regard, the Preamble further states:

> 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

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> 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.

[44] In order to qualify under the market-making exemption, the hedging activity must be undertaken by the trading desk engaged in market-making. If a different trading desk at the banking entity were to put on a hedge other than the trading desk engaged in market-making, the market-making exemption is not available. In that case, the risk-mitigating hedging exemption could be relied upon, but such reliance would include additional documentation and other requirements. 79 Fed. Reg. at 5,618.

Banking entities with more than $10 billion in total consolidated assets that engage in permitted proprietary trading, such as market-making, are required to establish and maintain a Volcker Rule compliance program including the following six elements:

- policies and procedures that establish trading, exposure, and investment limits, and that are otherwise reasonably designed to ensure compliance with the Volcker Rule;
- internal controls reasonably designed to monitor compliance with the Volcker Rule;
- a management framework that delineates responsibility and accountability for compliance, and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation, and other matters requiring attention;
- independent testing and auditing for the effectiveness of the compliance program;
- training for trading personnel (and those involved in fund investment or sponsorship) to implement compliance; and
- record-keeping sufficient to document compliance, which a banking entity must promptly provide to the relevant Agency upon request and retain for five years (or such longer period as is required by the Agency).[45]

A more stringent compliance regime applies to banking entities that have aggregate combined assets in the United States of $50 billion or more, or if they engage in permitted proprietary trading, and have a minimum level of trading assets and liabilities that triggers the reporting requirements described below.[46] The Chief Executive Officer of a banking entity subject to this more stringent compliance regime will have to attest on an annual basis in writing that the banking entity has in place processes reasonably designed to achieve compliance with the Volcker Rule.[47]

Reporting Metrics. Banking entities that engage in market-making or other permitted activities are subject to specific reporting and record-keeping requirements if the average gross sum of the banking entity's trading assets and liabilities of its combined U.S. operations (excluding trading assets and liabilities involving U.S. government or agency obligations) equals or exceeds $50 billion (as of June 30, 2014), $25 billion (as of April 30, 2016), or $10 billion (as of December 31, 2016). Banking entities are required to report periodically various quantitative metrics to the relevant regulator, and maintain records of the preparation and content of those reports. Specifically, seven metrics are required to be measured daily and reported for each calendar month within 30 days of the end of the month (beginning in January 2015, within 10 days of the end of the month) for banking entities with significant trading ($50 billion or more in trading assets and liabilities).[48] All other banking entities subject to the reporting requirement must report the metrics for each calendar quarter within 30 days of the end of that calendar quarter unless the relevant agency notifies the banking entity in writing that it must report on a different basis. The purpose of these metrics is to assist banking entities and the relevant Volcker agency in determining whether the banking entities are complying with the Rule, including its exemptions. They must be calculated for each trading desk that engages in activity covered by the Volcker Rule.

Prudential Backstops. Activity under the market-making exemption (as with the riskless principal exemption noted above) is subject to the prudential backstops, which prohibit otherwise permitted proprietary trading if the trading: (i) would involve, or would result in, a material conflict of interest between the banking entity and its customers or counterparties; (ii) would result in a material exposure by the banking entity to high-risk assets or high-risk trading strategies; or (iii) would pose a threat to the safety and soundness of the banking entity, or the financial stability of the United States. The Volcker Rule release contemplates

[45] Volcker Rule __.20(b).

[46] Volcker Rule __.20(c) and Appendix B.

[47] Volcker Rule Appendix B. Banking entities with total consolidated assets of $10 billion or less that engage in covered proprietary trading or fund activities may satisfy the compliance program requirement by including appropriate

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Volcker Rule-specific references in their existing compliance policies and procedures. Volcker Rule __.20(f)(2).

[48] Volcker Rule __.20(d). The seven metrics are: (i) risk and position limits, and usage; (ii) risk factor sensitivities; (iii) Value-at-Risk and Stress VaR; (iv) comprehensive profit and loss attribution; (v) inventory turnover; (vi) inventory aging; and (vii) customer facing trade ratio. 79 Fed. Reg. at Appendix A.

that the Volcker Agencies will rely on the supervisory process to identify these conflicts, assets, and strategies.

COSTS OF THESE REQUIREMENTS AND IMPACT ON DERIVATIVES

Suffice it to say that these requirements — measuring near-term customer demand, the compliance program, metrics reporting, and prudential backstops — are complex, have been expensive for banking entities to implement, and likely will require considerable resources on an ongoing basis. The OCC estimated the compliance and reporting costs as from $402 to $541 million per year for the national banks that it supervises and acknowledged that total costs likely would be higher. The OCC noted that the estimates do not take into account indirect costs resulting from loss of liquidity, which the OCC believes will be an outcome of the rule.[49]

The estimates also do not take into account costs associated with registration as a swap dealer or security-based swap dealer with the CFTC or SEC. As discussed above, it is likely that most swaps activity under the business model would require a banking entity to register as a swap dealer, subject to the *de minimis* exception and with the exception of banking entities that solely engage in FX Swaps and FX Forwards. Banking entities who engage in security-based swaps under the model likely would have to register as security-based swap dealers, subject to the *de minimis* exception. It is noteworthy that the Volcker Agencies cite to the CFTC and SEC's Entity Definitions Release in describing market-making activity for derivatives under the exemption,[50] which would require registration with those agencies (subject to the *de minimis* exception).[51] Thus, in addition to the costs associated with compliance with Volcker Rule requirements, a banking entity likely would be subject to costs associated with registration as a swap dealer, in many cases, or as a security-based swap dealer. These costs are substantial and include not only costs associated with submitting a completed registration application, but also costs associated with ongoing regulatory obligations, including capital, margin, annual certifications of compliance with regulations by a chief compliance officer, reporting, and record-keeping requirements.

Although the OCC estimates that the seven largest market-making banks will account for the majority of compliance-related expenditures, these institutions likely will be in the best position to be able to afford these costs. Regional and smaller banking entities may not be able to do so. This may result in regional and smaller banks withdrawing from or substantially reducing their derivatives activity to eliminate or reduce these costs, or restructuring their activities as brokered, or agency trades. According to the most recent quarterly report issued by the OCC on bank trading and derivatives activities for the first quarter 2015, the top five commercial banks in the United States account for almost 96% of derivatives exposure in terms of notional amount.[52] Further driving liquidity into the largest banks may decrease competition and increase costs for market participants, which may have these compliance costs passed on to them.

CONCLUSION

It is clear that the Volcker Rule may have a number of unintended consequences. By virtue of its expansive application to derivatives and the cost of applicable exemptions, the rule, along with other regulations applicable to banking entities, may reduce the profitability of the banking entities' business model applicable to derivatives. As a result, regional and smaller banking entities who are less able to bear these costs may withdraw from derivatives trading (or engage in brokered or agency trades), which in turn may result in a greater concentration of derivatives activity in the largest banking entities. A likely consequence would be decreased competition and higher costs for customers of these entities. ■

[49] OCC Analysis of 12 C.F.R. Part 44 *available at* http://www.occ.gov/topics/laws-regulations/legislation-of-interest/volcker-analysis.pdf.

[50] 79 Fed. Reg. at 5,595.

[51] Volcker Rule __.4(b)(2)(vi). The market-making exemption requires that the banking entity be appropriately licensed or registered to engage in market-making activity.

[52] OCC's Quarterly Report, *supra* note 17.