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The Volcker Rule's Significant Impact on a Foreign Banking Organization's Proprietary Trading Activities

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This week, the three federal banking agencies and the SEC approved for comment a proposed regulation implementing Section 619 of the Dodd-Frank Act, more generally known as the "Volcker Rule." The 298-page proposal has yet to be published in the *Federal Register*, but the agencies have already agreed to an extended comment period for the proposal – running until January 13, 2012 – given the subject matter's significance.

Effective July 21, 2012, the Volcker Rule restricts proprietary trading activities and investing in or sponsoring of private equity funds by "banking entities" – defined by statute to include FDIC-insured depository institutions, bank holding companies, savings and loan holding companies, other entities that control an FDIC-insured depository institution, and foreign banks that are regulated as if they are bank holding companies under the International Banking Act (*i.e.*, foreign banks that have a U.S. branch or agency office, referred to as a "foreign banking organization"), ***as well as any entity that is affiliated with any of the foregoing.*** Thus, subject to certain exemptions, the Volcker Rule restricts proprietary trading and private fund activities by any foreign bank that maintains a U.S. branch or agency office, and by any of the foreign bank's affiliates (collectively, an "FBO").

This week's proposed rulemaking underscores the significant impact that the Volcker Rule will have on FBOs, summarized below.

The Regulation Adopts an Expansive, Presumptive Definition of "Proprietary Trading"

The proposal defines "proprietary trading" as

> engaging as principal for the *trading account* of the covered banking entity in any purchase or sale of one or more *covered financial positions*.[1]

[1] § _.3(b)(1).

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Covered financial position includes any long, short, synthetic, or other position in any security, derivative or a contract of sale of a commodity for future delivery or option on a contract of sale of a commodity for future delivery.[2]

Trading account is more broadly defined than in Dodd-Frank. Consistent with Dodd-Frank, the proposal defines *trading account* to include any account used to acquire or take covered financial positions principally for the purpose of

- short-term resale;
- benefitting from actual or expected short-term price movements;
- realizing short-term arbitrage profits; or
- hedging any of the foregoing.[3]

The proposal goes beyond this definition, however, and also defines *trading account* per se to include any account containing *covered financial positions* if the account is held by:

- an SEC-registered dealer or municipal securities dealer;
- a government securities dealer;
- a CFTC-registered swap dealer;
- a SEC-registered security-based swap dealer; or
- a person engaged outside the U.S. in the business of a dealer, swap dealer, securities-based swap dealer, without regard to whether the person is subject to U.S. regulation.[4]

Thus, the proposal automatically deems all securities and derivatives accounts held by an FBO-affiliated dealer, government securities dealer, swap dealer, security-based swap dealer, or their functional equivalents located outside the U.S. as a *trading account* subject to the prohibition on proprietary trading, and makes it incumbent on the FBO-affiliated entity either to qualify for an exemption or to terminate the activity.

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2 § _.3(b)(3). Excluded from the definition of *covered financial position* are loans, commodities, F/X, and currency. *Id.* A separate provision effectively exempts certain qualifying repurchase or reverse repurchase agreements and securities lending and borrowing agreements, as well as any covered financial positions acquired for bona fide liquidity management purposes to the extent meeting certain conditions set forth in the proposal. *Id.* § _.3(b)(2)(iii).

3 § _.3(b)(2)(i). *See* Dodd-Frank Act, § 619(h)(6) (*codified at* 12 U.S.C. § 1851(h)(6)), which defines a *trading account* to include "any account used for acquiring or taking positions in [certain] securities or instruments . . . principally for the purpose of selling in the near term (or otherwise with intent to resell in order to profit from short-term-price movements)."

4 § _.3(b)(2)(C). In addition, the proposal automatically deems *trading account* to include any account at a bank holding company or affiliate that is considered to be a covered position within the meaning of the Federal Reserve Board's Market Risk Capital regulations, 12 C.F.R. Part 225, App. E. *See* § _.3(b)(2)(i)(B). In addition, the proposal creates a rebuttable presumption that any other account that is used to acquire or take covered financial positions held for 60 days or less is also a *trading account*.

The Proposal Establishes a High Bar for Transactions "Solely Outside of the United States"

The Volcker Rule provides that FBOs are not subject to the prohibition on proprietary trading to the extent the trading activity occurs "solely outside of the United States." The proposal implements this exemption and requires that four criteria be satisfied for the transaction to be "solely outside of the United States":

- The FBO-affiliated entity conducting the purchase or sale is not organized under the laws of the U.S. or any state;
- No party to the purchase or sale (including the FBO affiliate's counterparty) is a resident of the U.S.;
- No personnel of the FBO-affiliated entity who is directly involved in the purchase or sale is physically located in the U.S.; and
- The purchase or sale is executed outside of the U.S.[5]

In order to avail itself of the exemption, the FBO must also be a "qualified foreign banking organization" ("QFBO") as defined in the Federal Reserve Board's Regulation K. In other words, the FBO's worldwide activities must be predominantly banking, and the FBO's banking activities must be predominantly outside the United States.[6] Any affiliates of an FBO that does not meet this QFBO requirement would be unable to rely on the *"outside of the United States"* exemption to the Volcker Rule's ban on proprietary trading.

The exemption would be available only to the QFBO's non-U.S. affiliates and could not be used by its U.S. branch or any U.S.-based entity, including any broker-dealer, swap dealer, or security-based swap dealer affiliate. With respect to the QFBO's non-U.S. subsidiaries, the exemption would be available only if the transaction does not involve any U.S. counterparty, any QFBO employees residing in the U.S., or any U.S. execution facility. Thus, if the transaction involves a U.S. counterparty, U.S. execution facilities, or U.S. employees, the QFBO affiliate must resort to *other* exemptions, and, if unable to do so, the QFBO affiliate simply cannot conduct the trade once the Volcker Rule's conformance period ends.

The Regulation's Other Exemptions are Limited in Scope

The proposal includes a handful of other exemptions, all of which are fairly narrowly circumscribed:

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5 § _.6(d)(3). The proposal acknowledges that the phrase "personnel directly involved in the transaction" would not encompass employees performing purely administrative, clerical, or ministerial functions for the FBO affiliate.

6 *See* 12 C.F.R. § 211.23(a).

- Trading ***on behalf of customers***, provided that (i) the FBO affiliate is acting as an investment adviser, commodity trading advisor, trustee, or fiduciary, the customer (and not the FBO affiliate) is the beneficial owner; or (ii) the transaction is conducted on a riskless principal basis;[7]
- Trading in certain ***government securities***, limited to U.S. government or certain U.S. agency securities, State securities, or municipal securities;[8]
- Purchases or sales of covered financial positions as part of an ***underwriting*** and subsequent distribution of securities on behalf of an issuer, provided that the transaction meets certain requirements set forth in the proposal and, provided further, that the FBO is a SEC-registered dealer (or exempt from registration) or, if located outside the U.S., is subject to substantive regulation as a dealer where it is located;[9]
- Purchases or sales of covered financial positions that rise to the level of ***market making*** as such term is defined by the proposal, provided that the FBO affiliate is a SEC-registered securities dealer, municipal securities dealer, government securities dealer, or securities-based swap dealer, or is a CFTC-registered swap dealer (or exempt from registration) or, if located outside the U.S., is subject to substantive regulation as a dealer, swap dealer, or securities-based swap dealer where it is located; [10]

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7 § _.6(b).

8 § _.6(a).

9 § _.4(a). The *underwriting* exemption further requires that:

> (i) the entity have in place an internal compliance program (discussed *infra*);
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> (ii) "the underwriting activities with respect to the covered financial position are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties";
>
> (iii) "[t]he underwriting activities . . . are designed to generate revenues primarily from fees, commissions, underwriting spreads or other income not attributable to" appreciation in value or hedging of its own positions; and
>
> (iv) "[t]he compensation arrangements of persons performing underwriting activities are designed not to reward proprietary risk-taking."

Id. In addition, a FBO affiliate relying on the *underwriting* exemption is required to provide periodic quantitative reports to the agencies (discussed *infra*).

10 § _.4(b). The *market making* exemption further requires that:

> (i) the entity have in place an internal compliance program (discussed *infra*);
>
> (ii) the individual trading desk or other organizational unit that conducts the transaction "holds itself as being willing to buy and sell, including through entering into long and short positions in, the covered financial position for its own account on a regular or continuous basis";
>
> (iii) the market making -related activities of the trading desk or other organizational unit that conducts the transaction "are, with respect to the covered financial position, designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties";
>
> (iv) "[t]he market making –related activities . . . of the trading desk or other organizational unit that conducts the purchase or sale are designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to" appreciation in value or hedging of its own accounts;

- *Risk-mitigating hedging activities*, provided the hedging arrangements satisfy the specific requirements and conditions of the proposal, including the requirement that the risks sought to be reduced are properly documented at the time of the initial purchase or sale;[11] and
- Transactions by certain regulated ***insurance companies***.[12]

The proposal makes clear that the burden is on the banking entity to establish the basis for the exemption to the satisfaction of the agencies. In other words, the proposal assumes that all transactions conducted in *trading accounts* of certain banking entities (such as a broker-dealer, swap dealer, security-based swap dealer, or a banking entity subject to the Market Risk Capital Rules) are illegal proprietary trading activities unless the banking entity establishes that one of the above exemptions applies.

(v) the market making –related activities of the trading desk or other organizational unit that conducts the transaction "are consistent with the commentary provided in Appendix B" (which provides regulatory guidance regarding the distinction between permissible market making and impermissible proprietary trading); and

(vi) "[t]he compensation arrangements of persons performing the market making –related activities are designed not to reward proprietary risk-taking."

Id. In addition, a FBO affiliate relying on the market making exemption is required to provide periodic quantitative reports to the agencies (discussed *infra*).

[11] § _.5. The *risk mitigating hedging* exemption further requires that:

(i) the entity have in place an internal compliance program (discussed *infra*);

(ii) the transaction "[h]edges or otherwise mitigates one or more specific risks . . . arising in connection with and related to individual or aggregated positions, contracts, or other holdings" of the entity;
(iii) the transaction "[i]s reasonably correlated, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate";
(iv) the transaction "[d]oes not give rise, at the inception of the hedge, to significant exposures that were not already present in the individual or aggregated positions, contracts, or other holdings of a covered banking entity and that are not hedged contemporaneously";
(v) the transaction "[i]s subject to continuing review, monitoring and management by the covered banking entity that: (A) Is consistent with the written hedging policies and procedures . . . ; and (B) Maintains a reasonable level of correlation, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate; and (C) Mitigates any significant exposure arising out of the hedge after inception"; and
(vi) "[t]he compensation arrangements of persons performing the risk-mitigating hedging activities are designed not to reward proprietary risk-taking."

Id. A FBO affiliate relying on the risk-mitigating hedging exemption is required to provide periodic quantitative reports to the agencies (discussed *infra*). In addition, if the unit conducting the hedging transaction is different from the unit the positions, contracts, or other holdings of which are being hedged, the banking entity must document purpose of the transaction, the risks being mitigated, and the unit conducting the hedge.

[12] § _.6(c).

The Regulation Imposes Significant Reporting, Recordkeeping and Compliance Obligations for FBOs Effective Next July

In addition, the proposal imposes onerous reporting, recordkeeping and compliance obligations on FBOs to the extent that the FBO or any of its affiliates maintains a *trading account* but relies on certain of the exemptions described above.

The scope of the reporting obligations are determined by the FBO's aggregate Volcker Rule activities on a worldwide basis and the nature of the FBO's exempted activities. With respect to reporting, if the FBO and its affiliates, on an aggregate basis, have worldwide trading assets and liabilities of $1 billion or more at the end of the four prior calendar quarters, the FBO must comply with the reporting and recordkeeping requirements of Appendix A of the proposal, which requires regular reporting of up to ten separate quantitative measurements.[13] On the other hand, if the FBO and its affiliates, on an aggregate basis, have trading assets and liabilities of $5 billion or more and rely upon the *market making* exemption, the FBO is subject to enhanced reporting and must report up to *twenty-two* separate quantitative measurements.[14] Reportable data must be gathered and compiled at the individual trading unit, organizational unit, and enterprise wide levels. Information must be reported monthly, within 30 days after the end of the month.

Reporting is required <u>only</u> with respect to transactions falling within the *underwriting, market making, government securities,* and *risk-mitigating hedging* exemptions. Thus, no reporting is required with respect to transactions conducted under the *"outside of the United States"* exemption. However, the amount of transactions "outside of the United States" is taken into account when determining whether the FBO is above the $1 billion threshold (and therefore subject to reporting at all), or whether the FBO is above the $5 billion threshold and subject to enhanced reporting. In all instances, records must be maintained for five years.

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[13] The reportable quantitative measurements vary depending on the which exemption is being used. With respect to the *market making* exemption, the required measurements include: (i) Comprehensive Profit and Loss; (ii) Portfolio Profit and Loss; (iii) Fee Income and Expense; (iv) Spread Profit and Loss; (v) Value-at-Risk; (vi) Comprehensive Profit and Loss Attribution; (vii) Comprehensive Profit and Loss to Volatility Ratio; (viii) Volatility of Comprehensive Profit and Loss; (ix) Volatility of Portfolio Profit and Loss; and (x) Portfolio Profit and Loss to Volatility Ratio. With respect to the *underwriting, government securities,* and *risk-mitigating hedging* exemptions, the required measurements include: (i) Value-at-Risk; (ii) Stress VaR; (iii) Risk Factor Sensitivities; (iv) Risk and Position Limits; (v) Comprehensive Profit and Loss; and (vi) Comprehensive Profit and Loss Attribution.

[14] (i) Value-at-Risk; (ii) Stress VaR; (iii) VaR Exceedance; (iv) Risk Factor Sensitivities; (v) Risk and Position Limits; (vi) Comprehensive Profit and Loss; (vii) Portfolio Profit and Loss; (viii) Fee Income and Expense; (ix) Spread Profit and Loss; (x) Comprehensive Profit and Loss Attribution; (xi) Pay-to-Receive Spread Ratio; (xii) Unprofitable Trading Days Based on Comprehensive Profit and Loss; (xiii) Unprofitable Trading Days Based on Portfolio Profit and Loss; (xiv) Skewness of Portfolio Profit and Loss; (xv) Kurtosis of Portfolio Profit and Loss; (xvi) Volatility of Comprehensive Profit and Loss; (xvii) Volatility of Portfolio Profit and Loss; (xviii) Comprehensive Profit and Loss to Volatility Ratio; (xix) Portfolio Profit and Loss to Volatility Ratio; (xx) Inventory Risk Turnover; (xxi) Inventory Aging; and (xxii) Customer-facing Trade Ratio.

In addition, the proposal requires the FBOs adopt compliance programs to the extent that the FBO or its affiliates maintain any exempted trading accounts. The scope of the compliance program varies depending on the FBO's aggregate Volcker Rule activities. If the FBO and its affiliates exempted have trading assets and liabilities that are less than $1 billion (or 10% of its total assets) at the end of any of the four prior calendar quarters, the FBO must adopt a compliance program including:

- written policies and procedures,
- internal controls,
- a management framework delineating responsibility and accountability for compliance,
- independent testing,
- employee training, and
- recordkeeping.[15]

If the FBO's trading activities exceed the above threshold, the FBO must adopt the far more extensive "programmatic compliance procedures" as described in Appendix C to the proposal.[16]

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[15] § _.20(b). To be eligible for this lower threshold, the FBO's private fund investing and sponsoring activities also must be less than $1 billion (or 10% of its assets) over the same period. Even if the FBO engages in *no* exempted proprietary trading or private fund investing activities anywhere in the world, the proposal would still require the FBO to have at least measures designed to prevent the FBO from engaging in exempted activities. § _.20(d).

[16] An FBO subject to the programmatic compliance procedures must establish a compliance program that meets an extensive list of minimum standards. In order to meet these standards, the program must address specific requirements with respect to each of six elements:

Internal Policies and Procedures. With respect to covered trading activities, polices and procedures must (i) specify how the banking entity evaluates the covered financial positions it takes, and how it identifies its trading accounts; (ii) identify and document every trading unit within the entity and how those units are organized; (iii) articulate clearly the mission and strategy of each trading unit; (iv) include a mandate for each trader setting out the scope of his or her activity, as well as any relevant prohibitions; (v) comprehensively describe the risks associated with each trading unit; (vi) establish and enforce policies regarding the use of risk-mitigating hedging instruments and strategies; (vii) explain how the mission and strategy of each trading unit complies with the proposed rule; (viii) promptly document, address, and remedy any violation of the Volcker Rule or the regulations.

Internal Controls. With respect to covered trading activities, internal controls must (i) be designed to ensure that each trading unit's activity is consistent with the description included in written policies and procedures; (ii) ensure that trading activity is conducted within the bounds of authorized risks, instruments, and products; (iii) establish and enforce appropriate risk limits; (iv) mandate analysis and quantitative measurement of covered trading activities to ensure compliance with relevant rules. Internal controls must provide for the regular monitoring of the effectiveness of the compliance program, and require prompt action to address any deficiencies.

Management Responsibility and Accountability. The board of directors and CEO are responsible for reviewing and approving the compliance program, which must be reduced to writing. Furthermore, the board and CEO are themselves responsible for setting an "appropriate culture of compliance," and must ensure that senior managers are properly able to implement and enforce this culture. Business line managers are also held accountable for the

Again, because the thresholds are calculated based on the FBO's aggregate worldwide basis, the amount of an FBO's transactions "outside of the United States" are taken into account when determining whether the FBO is subject to the base-level compliance requirements or the "programmatic compliance procedures." However, the proposal's compliance obligations apply to *any* banking entity engaged in exempted trading account activity, wherever located, and thus apply to non-U.S. affiliates of an FBO engaged in trading activities solely "outside of the United States." In other words, trading conducting "outside of the United States" is not subject to the proposal's reporting obligations but is subject to the proposal's compliance obligations.[17] For that matter, the only way for an FBO to avoid these compliance obligations would be to terminate all proprietary trading activities worldwide or to close its U.S. branch or agency office.

The proposal states that banking entities are expected to adhere to the reporting, recordkeeping, and compliance obligations when the Volcker Rule goes into effect on July 21, 2012. Moreover, while banking entities are permitted to seek conformance extensions to the Volcker Rule, these extensions pertain solely to the banking entity's continuation of impermissible proprietary trading and private fund activities themselves, not to the reporting, recordkeeping, and compliance obligations. <u>Thus, FBOs must have the required reporting, recordkeeping, and compliance procedures in place by July 21, 2012.</u>

The Regulation Requires Conformance Extension Requests to be Filed

The proposal also discusses the process to be used in seeking conformance extensions to the Volcker Rule. The Federal Reserve previously issued final regulations regarding the availability of the

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implementation and enforcement of the compliance program with respect to the applicable trading or asset management unit.

Independent Testing. A qualified independent party must assess, with appropriate frequency, the efficacy and comprehensiveness of the compliance program as well the covered banking entity's compliance with relevant rules.

Employee Training. Training should be provided to trading personnel and managers of the covered banking entity, as well as any other appropriate personnel. It must occur with appropriate frequency and may be conducted by internal or independent parties.

Recordkeeping. The covered banking entity must create and retain records that sufficiently demonstrate the effectiveness of, and support for, its compliance program. The entity must retain these records for no less than five years in an easily accessible form.

[17] The Supplementary Information accompanying the proposal states that any such compliance program can be an enterprise-wide compliance program, but in any case may be structured and managed "in a manner that best reflects the unique organization and operation of the banking entity and its affiliates and subsidiaries, and is suitable taking account of the size, scope, and complexity of activities . . . in which the banking entity and its affiliates and subsidiaries engage."

extension periods, including the time periods in which requests should be filed.[18] The recent proposal re-codifies these requirements.

The prior regulations stated that extension requests must be filed 180 days prior to the expiration of authority. The proposal does not alter this requirement. The initial two-year extension period appears to be automatic, however, suggesting that no former filings are required for this initial extension.

In addition, the proposal's accompanying Supplementary Information discusses the ability of banking entities to continue existing activities after July 21, 2012. The proposal states:

> [T]he [Federal Reserve Board] expects that each banking entity will identify those trading units of the banking entity that are engaged in prohibited proprietary trading as of or after [July 21, 2012] and the type of proprietary trading in which they are engaged. A banking entity is expected to bring the prohibited proprietary trading activity of a trading unit into compliance with the requirements of the proposed rule as soon as practicable within the conformance period. A trading unit may not expand its activity to include prohibited proprietary trading after the effective date of the proposed rule. Similarly, a trading unit that is not identified as engaging in proprietary trading as of the effective date may not begin engaging in such activity after the effective date.

Thus, the proposal indicates that the trading unit may continue to operate during the conformance period but may not expand the scope of its activities, and no other trading units may commence impermissible proprietary trading activities after the effective date.

Conclusion

The Volcker Rule's proprietary trading ban will likely have a material adverse effect on FBOs. FBOs will be required to conform their global trading activities to ensure that their activities remain "outside of the United States" or otherwise fall within a listed exemption. The magnitude of a FBO's non-U.S. trading activities will affect the scope of the reporting obligations for any U.S.-based transactions, and an FBO will be required to adopt compliance procedures for non-U.S. trading entities even if those entities trade solely outside of the United States. These onerous reporting and compliance procedures must be put in place rapidly, *i.e.,* by July 21, 2012. These requirements are unusual, in that non-U.S. subsidiaries of FBOs are being expected to establish compliance procedures mandated by U.S. law merely because the FBO happens to maintain a branch or agency office in the U.S., and it is unclear how these requirements will be received by

[18] *See* Notice of Final Rulemaking, Board of Governors of the Federal Reserve System, *Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities,* 76 FEDERAL REGISTER 8270 (Feb. 14, 2011).

both FBOs and regulators abroad. Under the circumstances, it seems not unlikely that some FBOs will at least consider terminating their U.S. branch or agency office in order to escape the obligations of the Volcker Rule.

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