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Summary of the Volcker Rule Study – Proprietary Trading

Summary as of January 19, 2011

Overview: Broad Principles and Acknowledgment of Gray Areas but Still a Long Way to Go Before Rules Are Final

The Financial Stability Oversight Council's ("**FSOC**" or the "**Council**") study[1] on the Volcker Rule calls for robust implementation of the core proprietary trading prohibition while acknowledging the existence of difficult gray areas, especially in the areas of market making and hedging. It also contemplates differential treatment of different asset classes. The study strongly supports the use of quantitative metrics as one compliance and supervisory tool and envisions the creation of a brand-new and strikingly intense compliance structure to constrain impermissible proprietary trading while also providing the regulatory authorities charged with implementing the Volcker Rule (collectively, the "**Agencies**")[2] with the ability to engage in supervisory oversight and enforcement.

The study sets forth a general framework to guide the Agencies in writing the rules and gives the Agencies a great deal of discretion rather than prescribing specific standards for the rules. That said, the study contains different levels of commentary including formal recommendations as well as statements for the Agencies to "consider" or to "strongly consider" when drafting the rules and it is to be expected that the Agencies will work within the study's general framework.

One key takeaway from the study, which does not formally ask for comments, is that the Agencies must engage in a great deal of further review, especially on the quantitative metrics, before they will be in a position to publish proposed rules, probably in the late spring/early summer with a view to final rules by the October 21, 2011 deadline. The other key takeaway is that both the firms and the Agencies will need to hire new staff and make systems and other operational changes to prepare for the proposed new tiered compliance, supervisory and enforcement procedures that will surround the implementation of the Volcker Rule. As a result, one of the "strongly consider" recommendations in the study is engagement by the Board of Directors and attestation by the CEO as to the adequacy of the Volcker Rule compliance systems and procedures.

Five Fundamental Principles

The study lays out five fundamental principles to guide the Agencies' rulemaking and implementation.

1. **Prohibit and Define Bright Line Proprietary Trading**. The Agencies should clearly prohibit what has been called "walled-off" proprietary trading and is called "bright line" proprietary trading activity by the study. Key elements are use of the banking entity's own capital and a unit organized to benefit from price movements. Other elements could include:

[1] The study was released at the January 18, 2011 FSOC meeting and is available on the FSOC's website at http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.

[2] These Agencies include the Office of the Comptroller of the Currency ("**OCC**"), the Federal Deposit Insurance Corporation ("**FDIC**"), the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission ("**SEC**") and the Commodity Futures Trading Commission ("**CFTC**"). Treasury has a coordination function.

- Organized to conduct trading activities for the sole purpose of generating profits from trading strategies;
- No formal market making responsibilities or customer exposure (or customer exposure that is not commensurate with the level of trading);
- Physical and/or operational separation from market making and other operations having customer contact;
- Trades with, or is provided, the services of sell side analysts, brokers, and dealers;
- Receives and utilizes research or soft dollar credits provided by other broker-dealers; and/or
- Compensation structures similar to those of hedge fund managers and other managers of private pools of capital.

2. **Dynamic and Flexible**. The regulations and supervision should be dynamic and flexible so Agencies can identify and eliminate prohibited proprietary trading as new products and business practices emerge. We believe this implies a combination of formal written regulation, compliance procedures and informal Agency guidance. As explicitly noted in the study, it also requires the hiring of new Agency staff with new skill sets.
3. **Horizontal Review and Application**. The regulations and supervision should be applied consistently across similar banking entities (*e.g.*, large banks, hedge fund advisers, investment banks) and their affiliates to facilitate comparisons.
4. **Predictable Outcomes**. The regulations and supervision should facilitate predictable evaluations of outcomes so Agencies and banking entities can discern what is a prohibited and a permitted trading activity.
5. **Different Asset Classes Treated Differently**. The regulations and supervision should sufficiently account for differences among asset classes.

Indicia of Permitted Activities

The study shows a great concern with creating a regulatory and supervisory system that will eliminate prohibited proprietary trading and prohibit the migration of prohibited proprietary trading into permitted activities partly because the permitted activities share outwardly similar characteristics with prohibited proprietary trading. As a result, the recommendations also contain indicia of permitted activities especially in the most difficult-to-identify categories of market making–related and hedging activities. These permitted activities are described as "limited and narrow" as well as subject to a "backstop" for material conflicts of interest and high risk trading strategies or assets. Permitted activities should be "for the ultimate benefit of the broader economy" while maintaining safety and soundness.

- **Market making–related activity**.
  - Includes derivatives and riskless principal trading.
  - References the SEC's discussion of bona fide market making in equity markets in a 2008 release on short selling,[3] and in particular indicia of publishing continuous two-sided quotations. However, the study does not note that published quotes are uniquely a part of the active equity markets, nor does it cite the statement in the 2008 release that "if the market

[3] The SEC release is available at http://www.sec.gov/rules/final/2008/34-58775.pdf.

maker does not incur any market risk with respect to a transaction or related set of transactions, the market maker may not be involved in bona-fide market making activities."

- The study notes different indicia for less liquid markets such as debt, derivatives or asset-backed securities, which also are less restrictive:
  - Purchasing or selling the financial instrument from or to investors in the secondary market (the study does not note that bona fide market makers normally also trade with other dealers);
  - Holding oneself out as willing and available to provide liquidity on both sides of the market (*i.e.*, regardless of the direction of the transaction);
  - Transaction volumes and risk proportionate to historical customer liquidity and investment needs; and
  - Generally does not include accumulating positions that remain open and exposed to gains or losses for a period of time instead of being promptly closed out or hedged out to the extent possible.

- **Risk-mitigating hedging**. Hedging activity should be designed to reduce the key risk factors in the banking entities' existing exposure, and should offset gains or losses that would arise from those exposures. Hedging activity should adjust over time based on changes in a banking entity's underlying exposures.
  - Two essential characteristics of risk-mitigating hedging:
    - The hedge is tied to a specific risk exposure; and
    - There is a documented correlation between the hedge and the exposure, with a "reasonable level of hedge effectiveness" when put into place.
  - Hedging activity should also adjust over time if market conditions alter the effectiveness of the hedge even if the underlying positions remain unchanged.
  - Material changes in risk should generate a corresponding change in hedging activity and should be consistent with the desk's hedging policy.
  - Factors Agencies could consider include:
    - the nature of risks hedged;
    - the extent to which banks evaluate risk at a portfolio level and include portfolio hedging in formal hedging strategy;
    - whether trader compensation is linked to earnings on hedging activity; and
    - the overall efficacy of portfolio hedging in reducing entity-wide risk.
- **Underwriting**. Suggested factors for Agencies to consider as indicia include:
  - Assisting an issuer in capital raising;
  - Performing due diligence;
  - Advising the issuer on market conditions and assisting in preparation of registration statement;
  - Purchasing securities from an issuer for resale to the public;
  - Participating in or organizing a syndicate of investment banks; and

  - Transacting to provide a post-issuance secondary market to facilitate price discovery.
- **Transactions on behalf of customers**. No indicia or detail are provided.
- **Transactions in government securities**. Contrary to the first four permitted activities, the statute is described as "broadly permit[ting] all transactions in these government securities" subject to the backstop.
- **Certain insurance activity**. Specific allowances for insurance companies' general accounts reflect the structural differences between banking and insurance and should be considered. These are discussed in greater detail in Annex B.
- **Investments in small business investment companies, public welfare investments and certain qualified rehabilitation expenditures under federal or state tax laws**. The study flatly states that these investments benefit the broader economy. There is no specific mention of venture capital.
- **Certain offshore activities**. No new examples are provided but there is a statement that offshore activities by non-US entities do not benefit from the discount window or federal deposit insurance.
- **Other activities** that Agencies determine would promote and protect the safety and soundness of banking entities and US financial stability. No examples are provided and no recommendation is made as to when the other activities might be invoked.
- **Activities implicating the scope of the Volcker Rule**.
  - **Loan trading and securitization**. The study acknowledges the statutory rule of construction preventing the Volcker Rule from limiting or restricting otherwise permitted sale or securitization of loans. The study notes that loan creation is economically essential and that Congress determined that neither the Volcker Rule itself nor the "backstop" should apply, although it counsels Agencies to "ensure that its implementation does not undermine" the proprietary trading prohibition. The study is silent on the issue of whether loans can be purchased with a view to resale.
  - **Asset-Liability Management**. The study recognizes that asset-liability management ("**ALM**") activities are clearly intended to be permitted and are important to safety and soundness. There is a specific statement that a finding that ALM activities are impermissible would adversely impact liquidity and interest rate risk management as well as exacerbating excess liquidity conditions. At the same time, the study counsels Agencies to verify that no prohibited proprietary trading is occurring within ALM portfolios. It is not made clear whether the compliance and supervisory structures in the rest of the study would apply to ALM.

Challenges in Distinguishing Prohibited Proprietary Trading from Permitted Activities

In connection with the indicia above, the study outlines a series of challenges for Agencies. These will largely be familiar to those following this area and are summarized in Annex A.

Four-Tier Implementation and Supervisory Framework

The study recommends a four-part implementation and supervisory framework that would assist Agencies in identifying proprietary trading activities that must be eliminated or permitted, consisting of:

1. **Programmatic Compliance Regime**. The FSOC recommends that banking entities be required to develop robust internal controls and new compliance regimes (that will include strong investment and risk oversight) designed to ensure that prohibited proprietary trading does not migrate into permitted activities.

- **New policies and procedures**. The new compliance regime may require the establishment of internal policies and procedures to detect and eliminate proprietary trading. Developing such policies could prove useful in avoiding a "one size fits all" approach. These might include requiring comprehensive mission/strategy statements for all trading activity including:
  - The mandate of each trading unit or profit center;
  - A description of how revenues are generated and positions are hedged;
  - An enumeration of activities engaged in by the trading unit or profit center;
  - Detail of the types of customers served;
  - A description of the activity typical of the customer base;
  - A listing of the types of products approved for transactions; and
  - A description of the compensation policy for those engaged in risk-taking activities.
  - Such policies and procedures could require firms to articulate the "types and levels of risk" necessary for each trading unit's mission and strategy, and to justify such risks in light of the Volcker Rule.
    - This justification could "serve as an important anchor" for supervisory assessment.
- **New controls and risk limits**. The study recommends the development and implementation of a program of controls to monitor trading activity and to ensure that the types and levels of risk taken are appropriate and consistent with articulated Volcker Rule policies and procedures. Potential requirements include:
  - Establishing authorized risks, instruments and products designed to ensure that all covered trading activity remains consistent with approved policies and procedures;
  - Establishing procedures to analyze revenues to discern the nature of trading activity conducted, including the key drivers of profitability and losses. Sources of revenue that Agencies may wish to consider include:
    - customer income, such as commissions, fees, bid/offer spread and inception booking profit & loss;
    - risk income or income associated with changes in market variables;
    - volatility of daily revenues over time, including volatility of customer and risk income; and
    - other factors, including revenues associated with changes in valuation model structure or assumptions.
  - Establishing risk limits to ensure that risk-taking is appropriately constrained in a way that disallows prohibited activities.
    - Such limits may be set in light of trading unit mission and strategy statements enumerated in internal policies.
    - Appropriate limits to be considered by Agencies may include constraints on risk-taking as measured by Value at Risk ("**VaR**") models, portfolio stress testing and profit and loss ("**P&L**") sensitivities associated with changes in market prices. Such limits could be implemented across profit centers, asset classes and market segments; and

- Establishing stop-loss limits in order to trigger reviews and potentially ceasing trading activity when such limits are met or exceeded.

- **Recordkeeping and reporting systems**. The creation of recordkeeping and reporting systems to enable internal compliance reviews and supervisory examinations including studies by trading units on how much revenues are driven by customer activity or changes in specified market factors. Agencies should consider requiring that trade-level data be maintained.

- **Independent testing (similar to bank secrecy and anti–money laundering procedures)**. The implementation of independent testing of the compliance regime by a banking entity's internal audit department or by outside auditors, consultants or other qualified independent parties. Expectations would vary by size and risk profile of the banking entity. Such independent testing might include:
  - an evaluation of the overall adequacy and effectiveness of the compliance regime;
  - testing for specific compliance with the Volcker Rule;
  - an analysis of appropriate breadth of coverage; and
  - an evaluation of pertinent management information systems.
  - The testing could assist the Board of Directors and senior management in identifying areas of weakness or need for stronger controls, and could serve as a tool for supervisors to use in assessing Volcker Rule compliance.

- **Board engagement and CEO public attestation**. The study contemplates robust review of permitted activities to ensure that internal policies and procedures are being followed, combined with engagement by the Board of Directors and asks Agencies to "strongly consider" public attestation of compliance by the Chief Executive Officer. It is expected that programs approved by the Board of Directors and the CEO will designate an individual or individuals responsible for compliance and include training.
  - The Board of Directors could be made responsible for such matters as:
    - approving the compliance program;
    - overseeing the structure and management of the banking entity's Volcker Rule compliance;
    - setting an appropriate culture of compliance; and
    - ensuring that policies are adhered to in practice.
  - The CEO could be made responsible for such matters as:
    - communicating and reinforcing the compliance culture established by the Board of Directors;
    - implementing the program;
    - reporting to the Board of Directors and the banking entity's supervisors on the effectiveness of the program; and
    - escalating compliance matters as appropriate.
  - The recommendation that agencies should also strongly consider requiring the CEO to attest publicly to the ongoing effectiveness of the internal compliance regime is similar in concept to the familiar Sarbanes-Oxley certifications and, while it is a surprise, should be

possible if it relates to the design and implementation of the systems. As written, it is more realistic than the CFTC proposed certifications by Chief Compliance Officers for swap dealers and it is to be hoped that the CFTC takes the FSOC's more nuanced view into account in its own rules.

2. **Analysis and Reporting of Quantitative Metrics**. The study outlines four categories of quantitative metrics and comes down firmly on the side of metrics as one useful tool if carefully used.

   - A metrics-based approach would be designed to:
     - Bring trends or incidents potentially indicative of violations to supervisory attention.
     - Facilitate the comparison of data across banking entities, market segments or trading strategies.
   - Metrics could include:
     - **Revenue-based metrics**. These metrics evaluate daily revenue and revenue from specific trades compared to historical revenue and horizontal comparisons with other banking entities. Other potential metrics include Day One Profit & Loss and Bid-Off Pay-to-Receive Ratio.
     - **Revenue-to-risk metrics**. These metrics attempt to measure revenue generated per unit of risk assumed. They include Profitable Trading Days (as a percentage of total trading days), Sharpe Ratios, Revenues to VaR, and VaR.
     - **Inventory metrics**. These metrics include Inventory Turnover and Inventory Aging. The study acknowledges that more nuanced calculation may be required for less liquid assets and suggests "factor-based" measures that "relate to the key drivers of valuation" and may already be in use by many firms.
     - **Customer-flow metrics**. These metrics compare the volume of customer-initiated orders on a market making desk against those orders that are initiated by a trader for hedging or building inventory. The study asserts that trader-initiated flow should be closely correlated with customer-initiated flow. Other such metrics are Customer-Initiated Flow to Inventory and Revenue to Customer Initiated Trades. These metrics are a bow in the direction of Senators Merkley (D-OR) and Levin's (D-MI) proposed trade-by-trade enforcement but do not contemplate full-on trade-by-trade enforcement.
     - **Other metrics identified in the future**.
   - **Other considerations**. The FSOC takes the view that any single quantitative metric is likely to produce false positives and false negatives, and thus the study states that metrics are best used as a source of information for further study. Their relevance is expected to vary significantly depending on asset class, liquidity, trading strategy and market profile of the trading activity.
     - Even though a single metric may be limited, a combination may be a powerful tool in identifying impermissible proprietary trading.
     - The study suggests the possibility of a standard quantitative profile of market making using cross-industry review on a desk-by-desk basis, firm specific operating experience and comparisons to stand-alone proprietary trading operations.
     - Other issues raised are the level of granularity (trading desk vs. business unit) and the frequency of measurement. On the latter point, the study acknowledges that "real time"

measurements will generate false positives and suggests that metrics may be measured on a trailing basis.

- It is suggested that the OFR might eventually have a role in assisting enforcement of the Volcker Rule due to its access to trading data.

3. **Supervisory Review and Oversight**. The study recommends that Agencies "strongly consider" incorporating certain supervisory components, but recognizes that some Agencies face "significant resource constraints." These recommendations include:
   - Conducting periodic review and testing of internal controls and procedures, including promulgating standards for evaluation of firms' practices;
   - Conducting ongoing monitoring and review of trading activities, potentially including collection of data such as trading exposures and revenues;
   - Maintaining frequent communication with trading personnel, both through monitoring and in examinations; and
   - Reviewing quantitative metrics reported by firms for red flags.
4. **Enforcement Procedures for Violations**. If a violation is identified through the examination process, the statute requires that the activity be terminated and that the investment be liquidated.
   - This remedy should not preclude Agencies from considering other potential supervisory or enforcement actions such as increased oversight, reductions in risk limits, increased capital charges or monetary penalties.

Application to Derivatives and Swaps

During and following the January 18, 2011 FSOC meeting, CFTC Chairman Gary Gensler emphasized that the Volcker Rule covers both cash instruments and derivatives and swaps. He called this "significant, as any risk that a banking entity could take on in the cash markets also could be expressed through swaps and derivatives."

- He further emphasized that banking entities' books, including those of swap dealers, are not precluded from the definition of "trading account" whether or not they held short-term or long-term positions in illiquid instruments such as swaps.

"Backstop" Statutory Limitations on Permitted Activities

The study refers to the portions of the Volcker Rule that make a permitted activity no longer permitted as a "backstop" and discusses them in a manner that does not inspire confidence that the ultimate rules will provide clarity. The possibility of safe harbors is not mentioned and the enforcement or supervisory impact of an activity falling out of a permissible activity is not discussed, although in the material conflicts of interest section the backstop is referred to as "prohibiting" the otherwise permissible activity, and in the high-risk trading strategies section it is referred to as "limiting" the otherwise permissible activity.

"Material Conflict[s] of Interest"

Material conflicts of interest are seen as central to the Volcker Rule, and this section of the study contains a general description of conflicts of interest (including, *e.g.*, a cursory discussion of other conflict of interest laws and a suggestion that Agencies take such laws into consideration) but provides little useful or helpful specifics on how it could or would be applied in connection with the Volcker Rule. This section thus is largely a punt to the Agencies.

"Material Exposure to High-Risk Assets or High-Risk Trading Strategies"

The study recognizes that guidance is needed and suggests that the Agencies consider a number of options, all of which are very vague and none of which are likely to lead to clarity. Among the comments are:

- Incorporate risk analyses into the supervisory framework to monitor permitted activities.
- Draw on the Section 620 study to help define those assets and investments that could pose excessive risk.
- Consider a flexible framework with an emphasis on the risk of serious loss.
- Consider use of an internal committee to assess high-risk assets and trading strategies.

Characteristics that may indicate a high-risk asset or a high-risk trading strategy include:

- The introduction of new products with rapid growth;
- Assets or strategies that include embedded leverage;
- Historical volatility of the asset or strategy;
- Total VaR of the asset or strategy;
- Assets whose values cannot be externally priced or whose exposure cannot be quantified;
- Assets whose risk cannot be adequately mitigated by effective hedging; and
- The application of capital and liquidity standards would not adequately account for the risk of an asset.

Finally, the study counsels Agencies to consider requiring firms to establish, or integrate into their risk management processes, "a committee with relevant expertise to assess the firm's potential exposure to high-risk assets and high-risk trading strategies."

"Pose[s] a Threat to Safety and Soundness of [a] Banking Entity"

This section contains no detail and thus seems like a deferral to the Agencies as well.

"Pose[s] a Threat to the Financial Stability of the United States"

The study states that a threat to financial stability is unlikely but provides no further detail.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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Challenges in Distinguishing Prohibited Proprietary Trading from Permitted Activities

The study lists the following challenges, which will largely be familiar to those following this area.

- **Inventory required for permitted activities** such as market making or underwriting could also be used for proprietary trading.
- **The amount of risk required** for permitted activities varies significantly by asset class.
- **Accumulating inventory in anticipation of**, rather than in response to, customer demand may resemble proprietary trading.
  - The study states, however, that market making–related inventory is likely to have a more predictable volume profile with respect to customer demand than a proprietary trading business would.
- Incomplete hedging can allow banks to conduct prohibited proprietary trading in the context of market making activities.
  - Here, the study acknowledges that in some cases it simply may not be possible or cost-effective to hedge fully.
- **Combinations of permitted activities** may circumvent the Volcker Rule.
  - This section asks the Agencies to consider, for example, the combination of the underwriting and hedging exemptions to create a proprietary trading book "layered on top of an underwritten security held in inventory."
- Especially for less liquid instruments, **determining the source of profits** is challenging.
  - Market making should be characterized by "rapid inventory turnover and minimal profits on inventory held," but evaluating where in the bid-offer spread a firm trades is difficult in markets where spreads are inconsistent or infrequently quoted.
- It is **difficult to disentangle** different sources of revenue.
- **Inter-dealer trading is necessary** in managing risk exposure but can be abused.
- **Measuring "near term" trading accounts and "short-term" price movements** depends on the liquidity of particular instruments and markets.
  - Thus "trading account" would not preclude illiquid instruments such as swaps.
    - Following the FSOC meeting, CFTC Chairman Gary Gensler emphasized this point. He called the fact that the study covers both cash instruments and derivatives "significant, as any risk that a banking entity could take on in the cash markets also could be expressed through swaps and derivatives."
  - The study advises Agencies to consider that proprietary trading can occur in instruments of varying maturities.
  - The study notes that the statutory language regarding short-term price movements resembles:

- Financial Accounting Standards Board ("FASB") language regarding whether a security is "held for trading"; and
- "A broader definition of 'covered positions' that are subject to the federal banking agencies' market risk capital rules."

- To the extent Agencies incorporate accounting or other terms, they should monitor changes in the underlying standards and ensure that changes in designation (*e.g.*, designating securities as "available for sale") cannot be used for circumvention.

Annex B

Accommodating the Business of Insurance

The study devotes additional space to the statutory mandate to "appropriately accommodate the business of insurance within an insurance company."

- Certain activities by insurance companies for their general accounts are permitted activities, subject to the statutory "backstops" discussed above.
- **Eligibility and Definitions**.
  - Only two types of insurers are subject to the Volcker Rule:
    - Insurance affiliates of insured banks or thrifts; and
    - Systemically important nonbank financial companies.
  - Agencies should consider defining three key terms, and should consult state insurance commissioners in doing so:
    - **"Regulated insurance company."** Could be defined as entities subject to regulation by state insurance authorities, as in Investment Company Act § 2(a)(17), but this might exclude some.
    - **"Directly engaged in the business of insurance."** Agencies should strive for consistency with terms already used and interpreted under the McCarran-Ferguson Act. Agencies should also think of the distinction between insurance units and holding companies when defining "directly engaging."
    - **"General account."** This is a recognized insurance term of art and does not include separate accounts.
- **Limitations on Qualified Activity**. The Volcker Rule requires insurance permitted activity to be conducted in compliance with state insurance investment law and that regulators not find such laws insufficient. The study offers little guidance but states that in the future, "Agencies will need to consider the timing and approach to the assessment" of such laws. The study also suggests safe harbor provisions for insurers and opportunities for states to address any inadequacies in investment law.
- **Separate Account Assets**. The study notes comments arguing that investments in separate accounts should be permitted under the "on behalf of customers" permitted activity but simply directs Agencies to consider the question.