

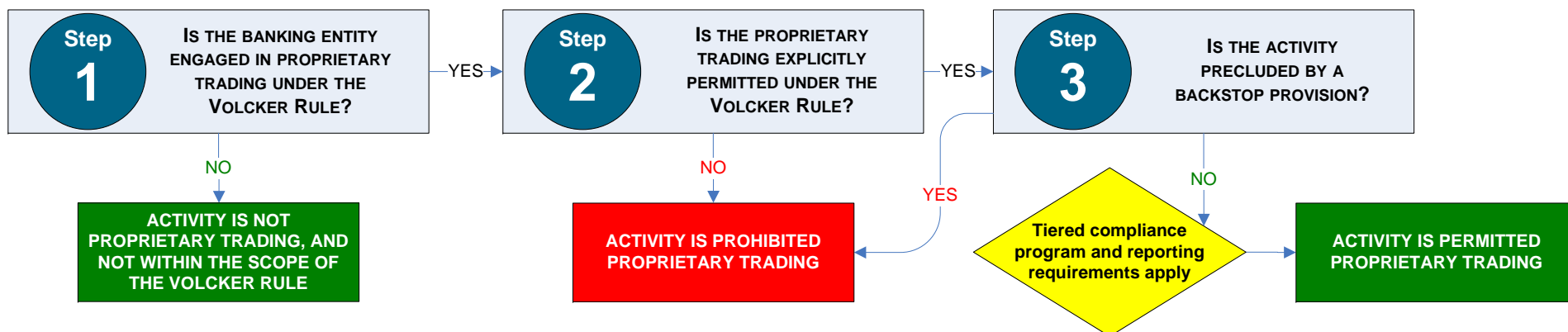


On October 11, 2011 the Federal Reserve, FDIC and OCC released proposed regulations implementing the Volcker Rule. The Dodd-Frank Act requires these three agencies and the SEC and the CFTC to consult and adopt rules restricting the ability of banking entities to engage in proprietary trading.

Comments on the proposal are due January 13, 2012. The statutory Volcker Rule prohibitions will become effective on July 21, 2012, whether or not regulations are finalized by that date.

To make our summary and analysis of the proposed regulations more user-friendly, we have prepared a set of flowcharts that graphically maps the key restrictions on proprietary trading in lieu of a traditional law firm memo.

We are also pleased to announce the launch of the Davis Polk Portal, the growing online hub of our regulatory resources. An interactive version of these flowcharts is available at [www.volckerrule.com](http://www.volckerrule.com), which is part of the Davis Polk Portal.





Step  
**1**

**IS A BANKING ENTITY ENGAGED IN PROPRIETARY TRADING UNDER THE VOLCKER RULE?**

- Is the principal position a **“covered financial position”**?
- Is the account a **“trading account”**?

NO

**ACTIVITY IS NOT PROPRIETARY TRADING, AND NOT WITHIN THE SCOPE OF THE VOLCKER RULE**

YES

Step  
**2**

**IS THE PROPRIETARY TRADING EXPLICITLY PERMITTED UNDER THE VOLCKER RULE?**

▪ Market Making-Related Activities	➔	▪ Trading in Government Obligations	➔
▪ Underwriting Activities	➔	▪ Trading on Behalf of Customers	➔
▪ Risk-Mitigating Hedging Activities	➔	▪ Trading by a Regulated Insurance Company	➔
		▪ Trading Outside the United States	➔

NO

**ACTIVITY IS PROHIBITED PROPRIETARY TRADING**

YES

Step  
**3**

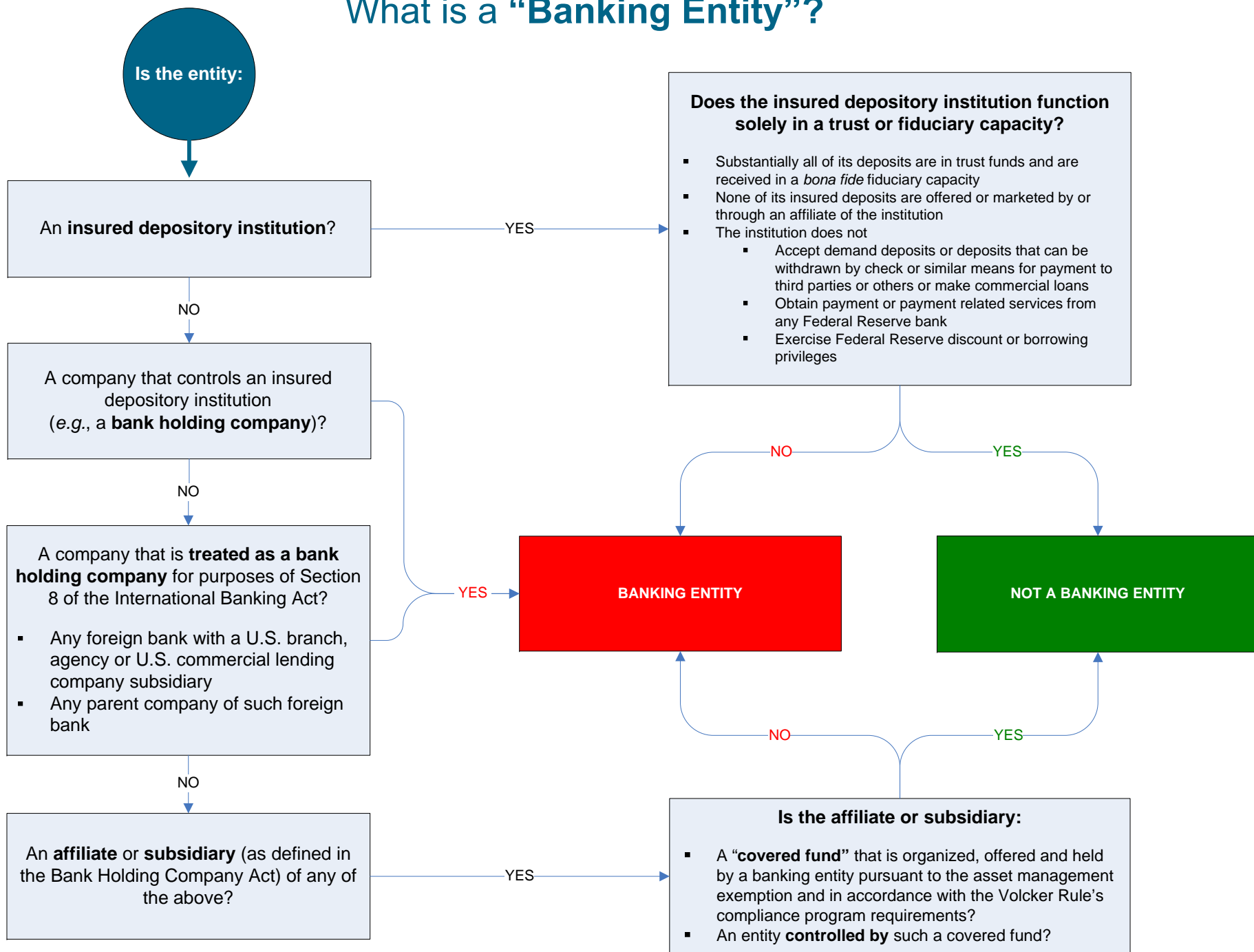
**IS THE ACTIVITY PRECLUDED BY A BACKSTOP PROHIBITION?**

- Material conflict of interest between the banking entity and its clients, customers or counterparties?
- Material exposure of the banking entity to high-risk assets or trading strategies?
- Threat to the safety and soundness of the banking entity or U.S. financial stability?

NO

**Tiered compliance program and reporting requirements apply**

**ACTIVITY IS PERMITTED PROPRIETARY TRADING**





Is the position a “covered financial position”?

IS THE PRINCIPAL POSITION IN ANY OF THE FOLLOWING?

- **Loan** (defined as any loan, lease, extension of credit or secured or unsecured receivable)
- **Spot commodity**
- **Spot foreign exchange or currency**

Proprietary trading does **not** include acting solely as **agent, broker or custodian for an unaffiliated third party.**

NO →

YES →

IS THE PRINCIPAL POSITION A POSITION IN ANY OF THE FOLLOWING—INCLUDING LONG, SHORT, SYNTHETIC AND OTHER POSITIONS?


- A **security** (as defined in section 3(a)(10) of the Securities Exchange Act), including an option on a security.
- A **derivative**, including an option on a derivative.
  - The term derivative includes:
    - any swap
    - any purchase or sale of a nonfinancial commodity for deferred shipment or delivery that is intended to be physically settled
    - any foreign exchange forward or foreign exchange swap as defined in the Commodity Exchange Act
    - agreement, contract, or transaction in foreign currency described in section 2(c)(2)(C)(i) of the Commodity Exchange Act
    - agreement, contract, or transactions in a commodity other than foreign currency described in section 2(c)(2)(D)(i) of the Commodity Exchange Act
    - any transaction authorized under section 19 of the Commodity Exchange Act
  - The term derivative does **not** include:
    - any agreement, contract or transaction jointly determined by the SEC and CFTC not to be a swap or security-based swap
    - **any identified banking product** under the Legal Certainty for Banking Products Act of 2000
- A **contract of sale of a commodity for future delivery**, or an option thereon, with “contract of sale” and “for future delivery” defined under the Commodity Exchange Act

“Commodity” is defined under the Commodity Exchange Act but does not include any security.

YES →

NO →

Position is a “covered financial position.”  
Go to next page.



ACTIVITY IS NOT PROPRIETARY TRADING, AND NOT WITHIN THE SCOPE OF THE VOLCKER RULE



# Is the Account a "Trading Account"?

Is the account a "trading account"?

- Is the account used to acquire or take covered financial positions that:
- Arise under a **repo** or **reverse repo** agreement pursuant to which the banking entity has simultaneously agreed, in writing, to both purchase and sell a stated asset, at stated prices and on stated dates or on demand with the same counterparty?
  - Arise under a **securities lending transaction** in which the banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and to recall the loaned security on terms agreed by the parties?
  - Are conducted for the *bona fide* purpose of **liquidity management** in accordance with a documented liquidity management plan? (See note to right)
  - Are acquired or taken by a banking entity that is a CFTC-registered **derivatives clearing organization** or an SEC-registered **clearing agency** in connection with clearing derivatives or securities transactions?

- The liquidity plan must:
- Specifically authorize the particular instrument, its risk profile and the liquidity circumstances in which it may be used
  - Require that any transaction contemplated and authorized be principally for managing liquidity, and not for short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits or hedging a short-term position
  - Require that any position be highly liquid and limited to financial instruments the risks of which the banking entity does not expect to give rise to appreciable profits or losses as a result of short-term price movements
  - Limit positions to an amount consistent with the banking entity's near-term funding needs (as estimated and documented by methods specified in the plan)
  - Be consistent with applicable regulator's supervisory expectations regarding liquidity management

ACTIVITY IS NOT PROPRIETARY TRADING, AND IS NOT WITHIN THE SCOPE OF THE VOLCKER RULE

YES TO **ANY** QUESTION

NO TO **ALL FOUR** QUESTIONS

## THREE WAYS TO MEET THE DEFINITION OF "TRADING ACCOUNT"

**PURPOSE TEST**

Is the account used to take one or more covered financial positions **principally for the purpose of** any of the following?

- Short-term resale
- Benefitting from actual or expected short-term price movements
- Realizing short-term arbitrage profits
- Hedging one or more such positions

**A rebuttable presumption of a trading account arises if the covered financial position is held for 60 days or less**

OR

**STATUS TEST**

Regardless of purpose, if the account is used to take one or more covered financial positions, is the banking entity any of the following?

- An SEC-registered securities dealer or municipal securities dealer
- A government securities dealer registered with the appropriate regulatory agency
- A CFTC-registered swap dealer
- An SEC-registered security-based swap dealer
- Engaged in the business of a dealer, swap dealer or security-based swap dealer outside of the U.S.

In each case, the status test only applies to the extent that trading activity is related to the status in question. For example, the first bullet only applies to the extent the position is acquired or taken in connection with the activities that cause the banking entity to be registered as a securities dealer or municipal securities dealer.

OR

**MARKET RISK CAPITAL RULE TEST**

If the banking entity or any affiliate that is a bank holding company calculates risk-based capital under the Market Risk Capital Rule, is the account used to take one or more positions covered by the Market Risk Capital Rule (other than FX derivatives, commodity derivatives or contracts of sale of a commodity for future delivery)?

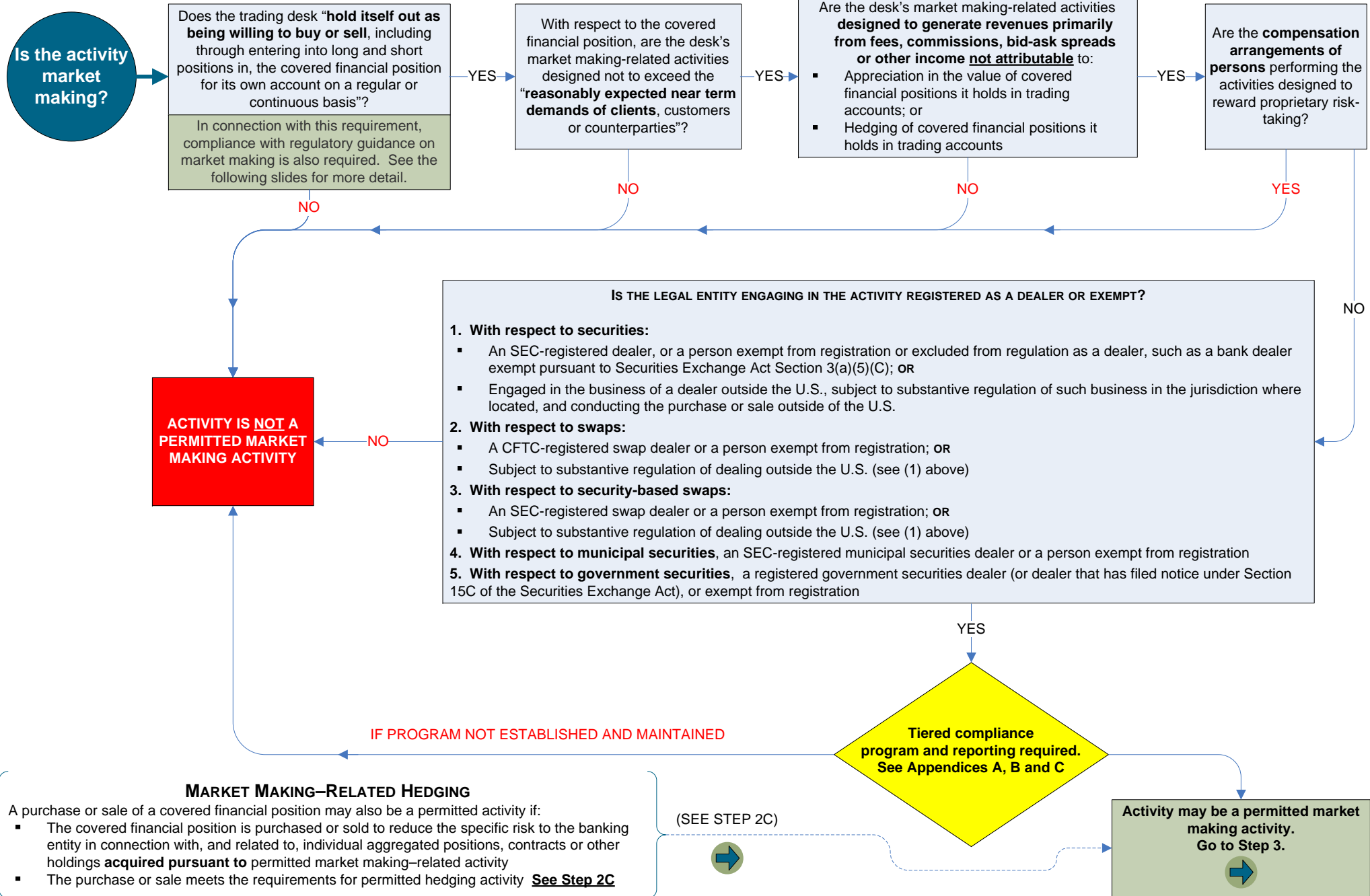
ACTIVITY IS NOT PROPRIETARY TRADING, AND IS NOT WITHIN THE SCOPE OF THE VOLCKER RULE

NO TO **ALL THREE** QUESTIONS

YES TO **ANY** QUESTION

The trading activity is proprietary trading within the scope of the Volcker Rule. Go to Step 2.

Permitted Activities: Market Making



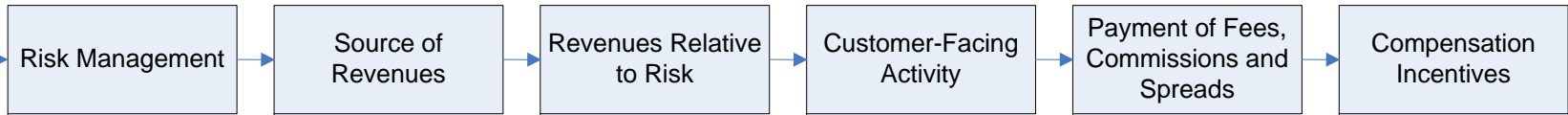
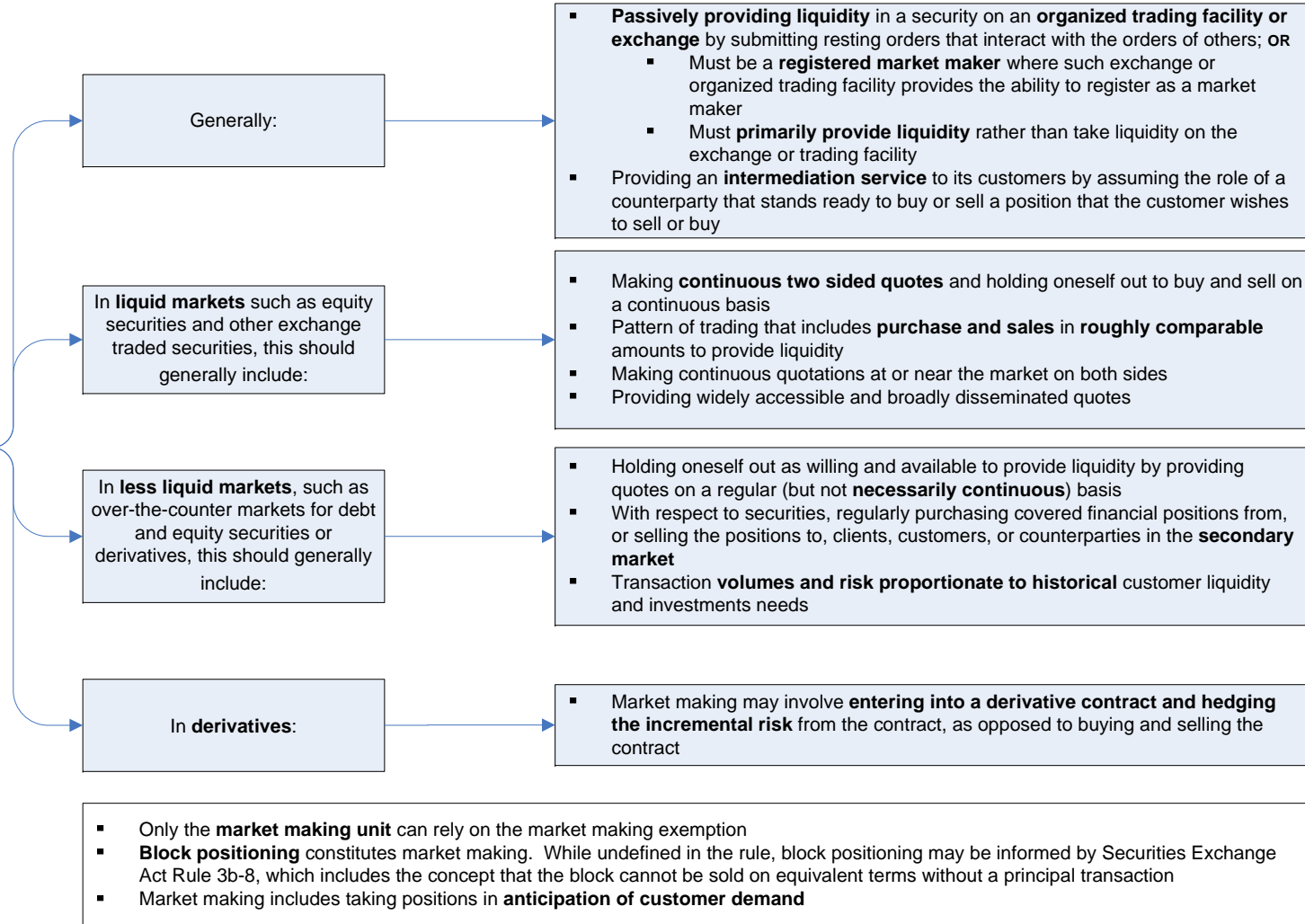
# Principles Distinguishing Market Making from Prohibited Proprietary Trading

What principles must be met for an activity to qualify as permitted market making?

A market maker must “hold itself out 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**.” This means:

Regulators will apply **six specific factors** to distinguish permitted market making from prohibited proprietary trading.

See the following slides for more detail.





# Principles Distinguishing Market Making from Prohibited Proprietary Trading

## Permitted Market Making

A market maker generally **manages and limits the extent to which it is exposed to movements** in the price of retained principal positions and risks or the price of one or more material elements of these positions. Risks may not be able to be fully hedged on a cost effective basis. Risk should not be retained in excess of the size and type required for market making.

A market maker generates revenues from **customer revenues**, rather than from price movements in retained principal positions/risks. Price movement losses or gains should be incidental to customer revenues and limited by hedging.

Regardless of movements in the price of retained principal positions and risks, a market maker typically generates significant revenue relative to the risks it retains. Thus market makers will typically demonstrate **low earnings volatility under normal market conditions**. Revenues should not be very small or very large per unit of risk taken.

A market maker's customers generally consist of market participants that make use of its **intermediation services**. Market makers focus on **servicing customer demands** and typically only transact with non-customers to the extent that such transactions directly facilitate or support customer transactions such as through hedging, acquiring positions in advance of customer demand, or selling positions acquired from customers.

To the extent that a market maker trades through a trading system that interacts with the orders of others, all market participants submitting orders are customers. In the over-the-counter market, all market participants using the market maker's intermediation services would be customers.

Market makers typically engage in transactions **that earn fees, commissions or spreads as payment for services**. Transactions in which the market maker pays fees, commissions or spreads are much less frequent. But in some cases, e.g., paying another market maker for providing liquidity services, may be necessary to prudently manage risk with respect to price movements in retained principal positions/risks. In derivative contracts, customer revenues reflect the difference between the cost of the contract and the cost of the hedge of the contract.

A market maker does not provide personnel compensation incentives that primarily reward proprietary risk-taking. Any incentives will instead **reward increased customer revenues and effective customer service**.

## Principles

**Risk Management**

**Source of Revenues**

**Revenues Relative to Risk**

**Customer-Facing Activity**

**Payment of Fees, Commissions and Spreads**

**Compensation Incentives**

## Prohibited Proprietary Trading

A prop trader **retains risk exceeding** the size and type required to provide **intermediation services** to customers.

A prop trader **primarily generates revenues from price movements** in retained principal positions/risks, rather than customer revenues.

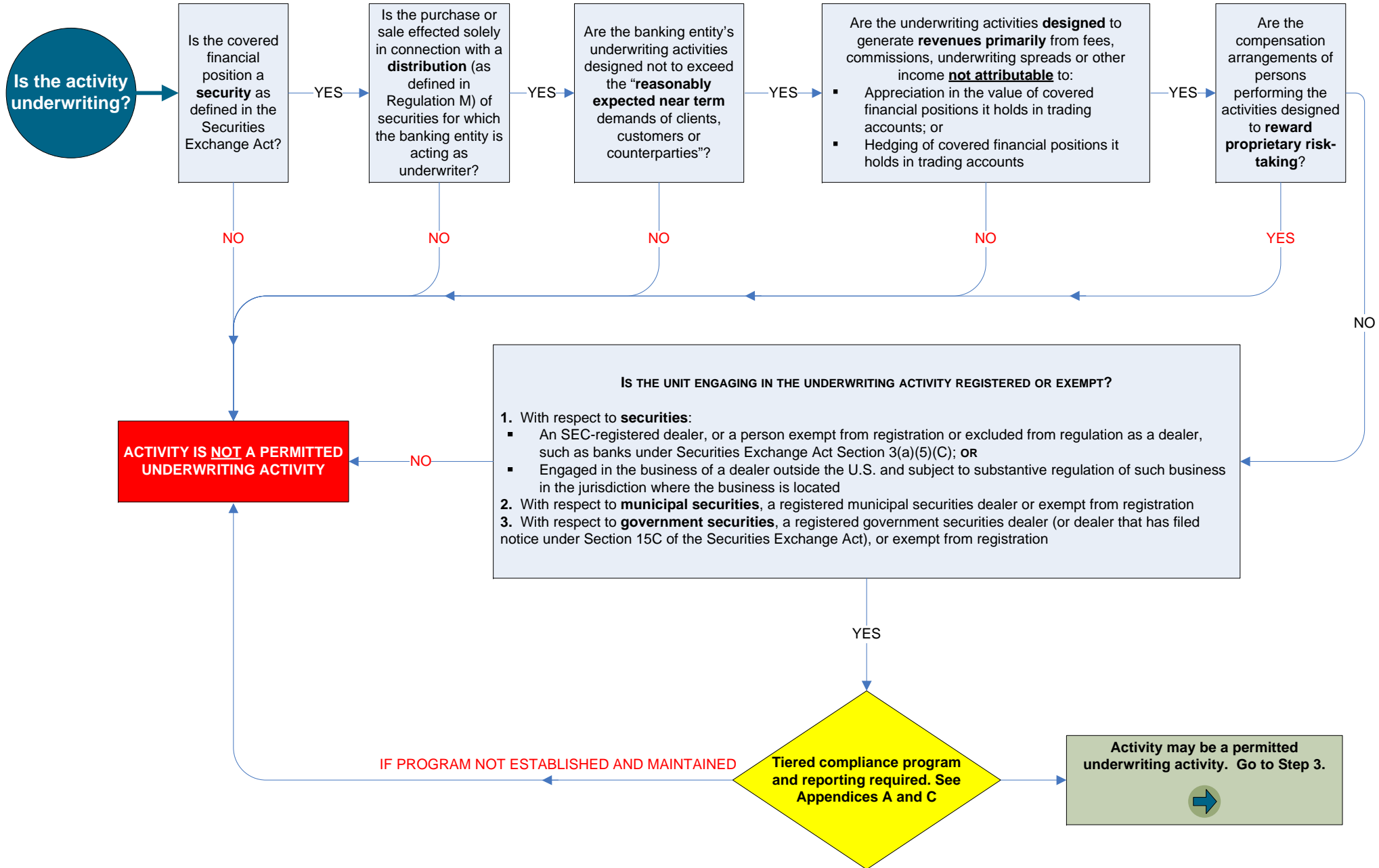
The prop trader will typically generate only **very small or very large amounts of revenue per unit of risk taken**, will not demonstrate consistent profitability and will demonstrate high earnings volatility.

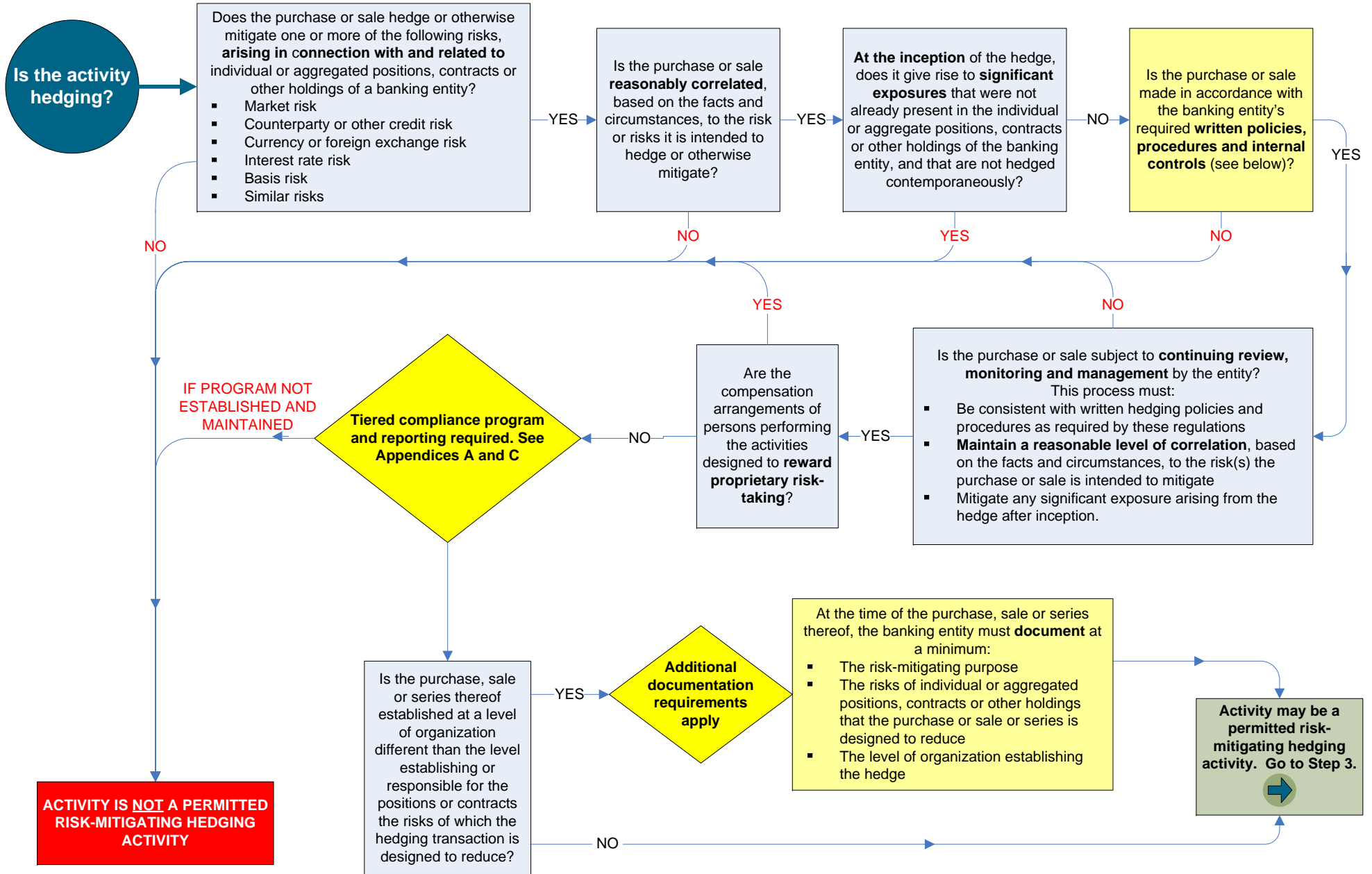
A prop trader does not transact through a trading system that interacts with orders of others or primarily with customers of the banking entity's market making desk to provide liquidity services. A prop trader **retains principal positions and risks in excess of reasonably expected near-term customer demand**.

A prop trader **routinely pays rather than earns fees, commissions or spreads**.

A prop trader provides employee compensation incentives that primarily **reward proprietary risk taking**.

Permitted Activities: Underwriting

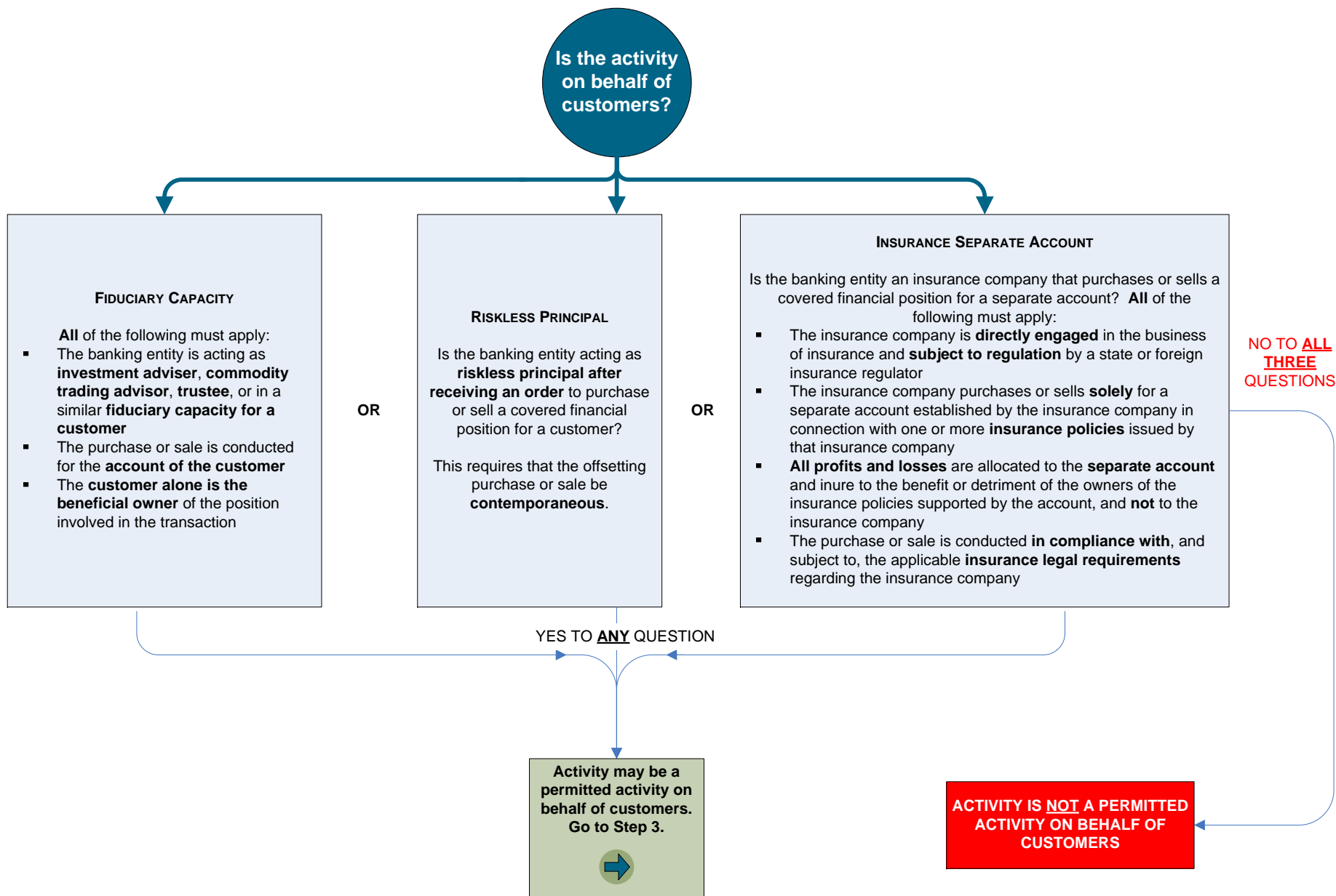


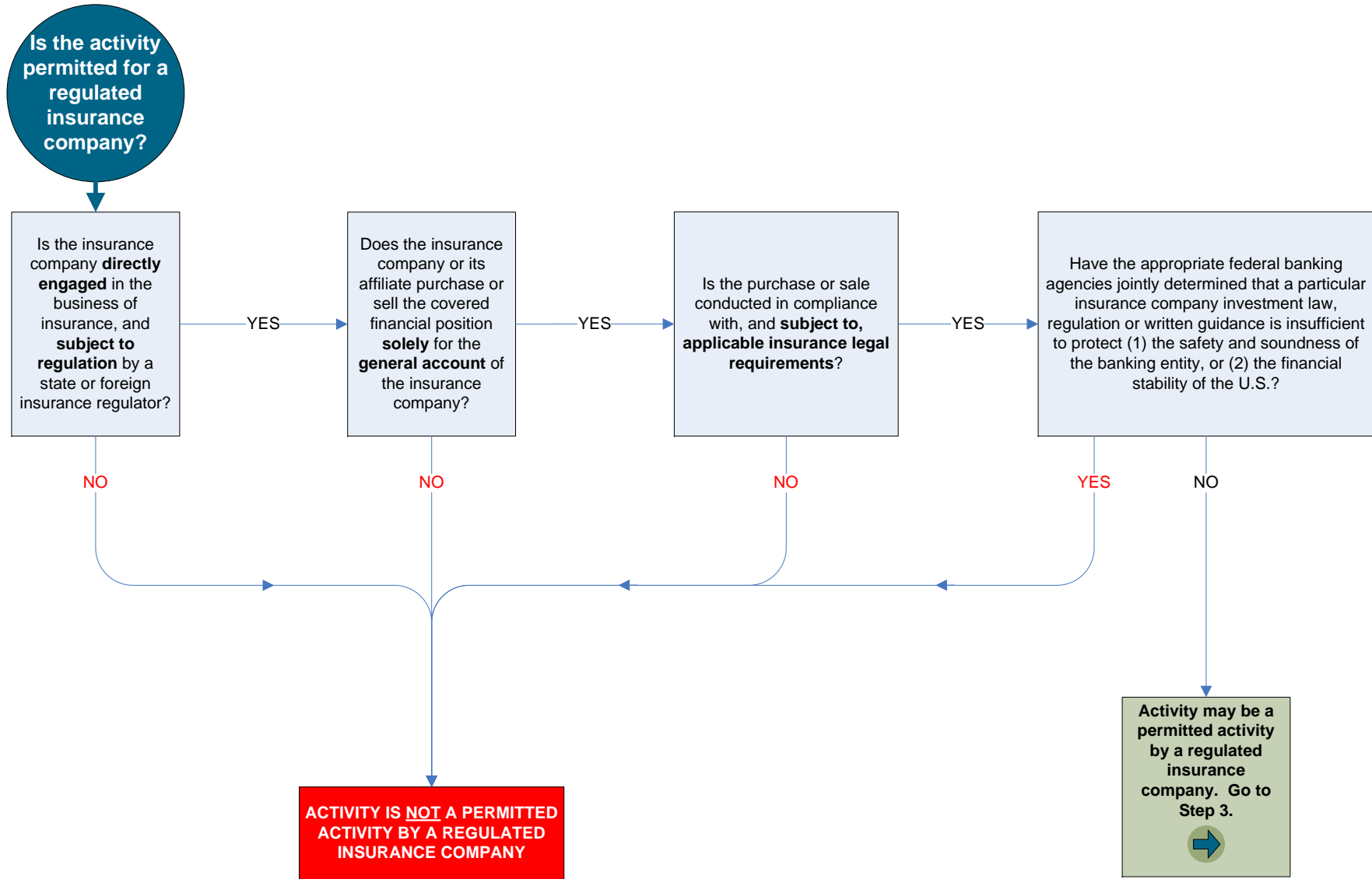




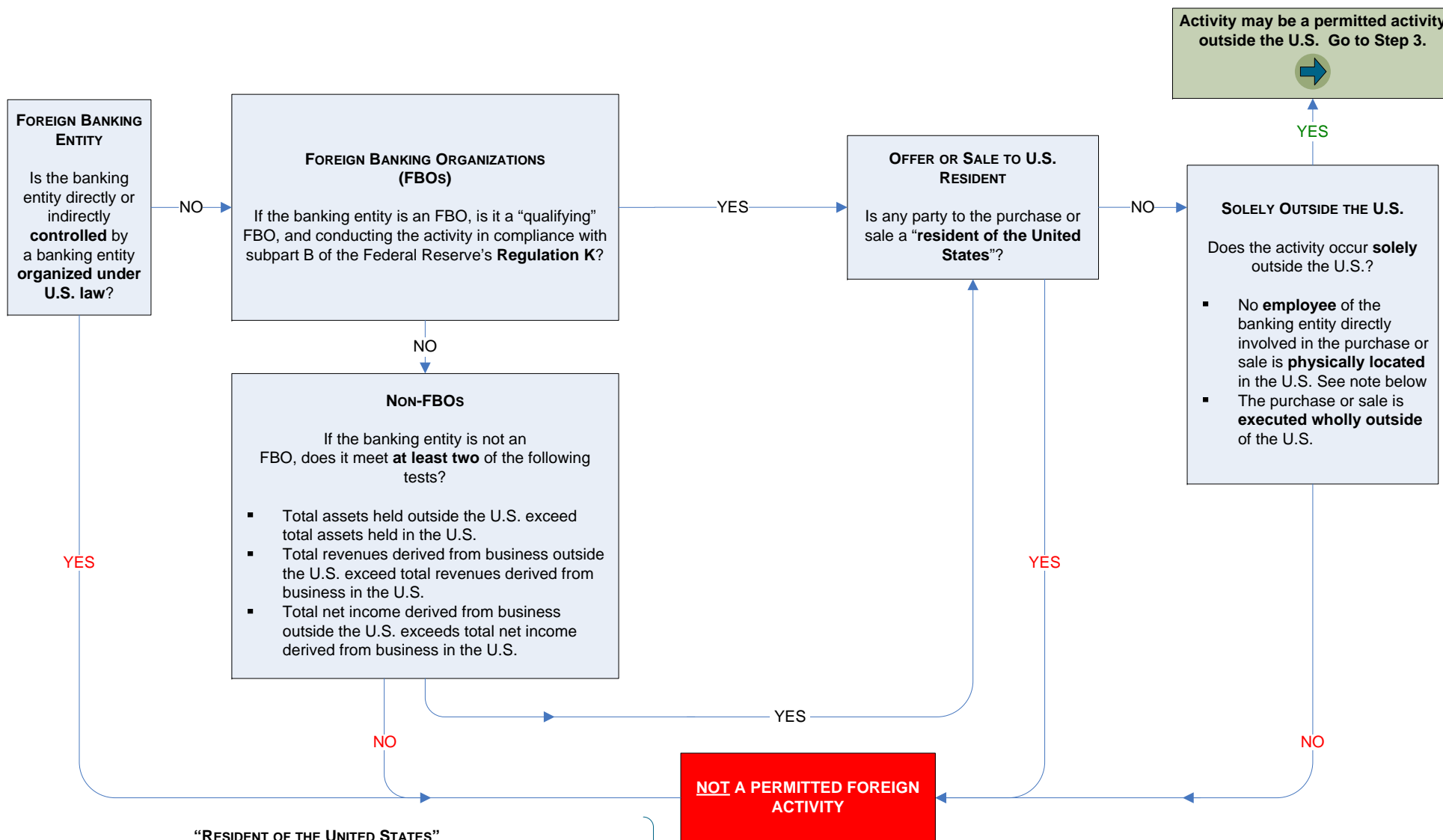


Only Three Ways to Qualify for the “On Behalf of Customers” Exemption





# Permitted Activities: Solely Outside the United States



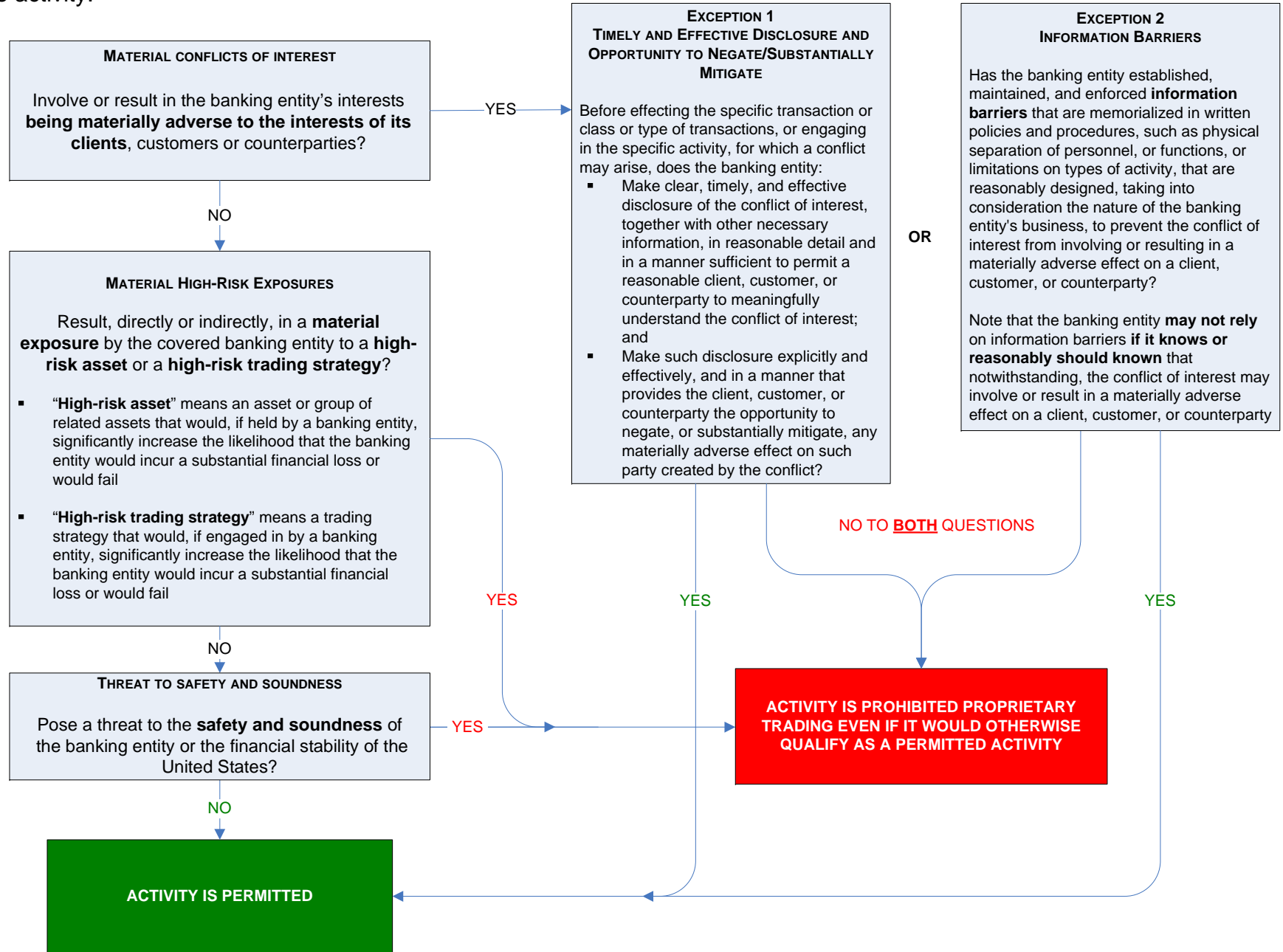
**“RESIDENT OF THE UNITED STATES”**  
Adapts and expands the definition of “U.S. person” in the SEC’s Regulation S:

- Includes discretionary accounts held for a U.S. person by a non-U.S. dealer or fiduciary
- Omits exclusions, including for:
  - Offshore branches and agencies of U.S. entities
  - Discretionary accounts held for the benefit of a non-U.S. person by a U.S. dealer or fiduciary

**MINISTERIAL EXCEPTION FOR U.S.-BASED EMPLOYEES**  
The preamble states that “[p]ersonnel directly involved in the transaction would generally not include persons performing purely administrative, clerical, or ministerial functions,” although this distinction is not explicitly reflected in the rule text.

# Is the Activity Precluded by a Backstop Prohibition?

Would the activity:





What compliance program requirement applies?

Does the banking entity engage in activities **within the scope** of the Volcker Rule, whether or not permitted?

YES

NO

**Basic compliance program required. Metrics may also be required per Appendix A**

- The covered banking entity must establish a compliance program that includes, at a minimum:
- Internal **written policies/procedures** reasonably designed to document, describe and monitor any banking entity activities in order to ensure that such activities comply with the statute and implementing rules
  - A system of **internal controls** reasonably designed to monitor and identify potential areas of noncompliance and prevent the occurrence of prohibited activities
  - A **management framework** that clearly delineates responsibility and accountability for compliance
  - Independent testing**, conducted by qualified banking entity personnel or a qualified outside party, of program effectiveness
  - Training** for appropriate personnel and managers to effectively implement and enforce the program
  - Maintenance of records** sufficient to demonstrate compliance with the Volcker Rule statute and implementing rules, retained for at least 5 years and provided to regulators upon request

**Preventive compliance program required**

- Policies and procedures only need include measures designed to prevent the entity from becoming engaged in such activities or making such investments
  - Policies and procedures must require the entity to develop and provide for the appropriate compliance program before commencing such activities or investments
- No further compliance program requirements apply**

**ADDITIONAL PROGRAM REQUIREMENTS\*\***

Does the banking entity engage in proprietary trading, and is the average gross sum of trading assets and liabilities on a worldwide consolidated basis (including affiliates and subsidiaries), as measured as of the last day of each of the four prior calendar quarters, either:

- At least \$1 billion; or
- At least 10% of total assets?

YES

NO

**No further compliance requirements apply beyond the basic compliance program requirements above**

**Enhanced trading-specific program required**

In addition to the basic requirement above, must satisfy the requirements of Appendix C with respect to proprietary trading activities  
**See the following slides for details**



\*\* The agency may also deem compliance with these additional program requirements appropriate, regardless of the tests listed here.



If Appendix C applies, what are the additional program requirements?

Program requirements apply at the "trading unit" level, which includes:

- Each discrete unit engaged in the coordinated implementation of a revenue-generation strategy and that participates in the execution of any covered trading activity
- Each organizational unit used to structure and control the aggregate risk-taking activities and employees of one or more trading units
- All trading operations, collectively
- Any other unit of organization specified by the agency

1

**INTERNAL POLICIES AND PROCEDURES**

- Identification of trading accounts
- Identification of trading units and organizational structure
- Description of trading unit missions and strategies
- Trader mandates
- Descriptions of risk management processes
- Hedging policies and procedures
- Explanation of compliance
- Description of how the banking entity monitors for and prohibits material exposure to high-risk assets or high-risk trading strategies
- Description of how the banking entity monitors for and prohibits potential or actual material conflicts of interest with its clients, customers, or counterparties
- Description of how the banking entity monitors for and prohibits potential or actual transactions or activities that may threaten the safety and soundness
- Remediation of violations

2

**INTERNAL CONTROLS**

- Be reasonably designed to ensure that the trading activity is conducted in conformance with a trading unit's authorized risks, instruments and products
- Establish and enforce risk limits
- Analysis and quantitative measurements (including numerical thresholds for heightened review)
- Take prompt action to address and remedy any deficiencies identified, and provide timely notification to regulator of actions taken

3

**RESPONSIBILITY AND ACCOUNTABILITY**

- Must have an appropriate management framework
- Board **and** CEO must review and approve the compliance program, set a culture of compliance and ensure appropriate incentives are in place
- Program must be written, approved by the Board, and noted in the minutes
- Mandates must be maintained down to the individual trader level, and at least one person must be designated with authority to enforce responsibilities for each trading unit
- Written procedures (including management review and compensation) must be in place
- Business line managers are accountable for program implementation and effectiveness
- Senior management and control personnel are responsible for implementing the compliance program and overseeing compliance

6

**RECORDKEEPING**

- Sufficient to demonstrate compliance and support program effectiveness
- Retain for a 5-year period and produce to regulators upon request

5

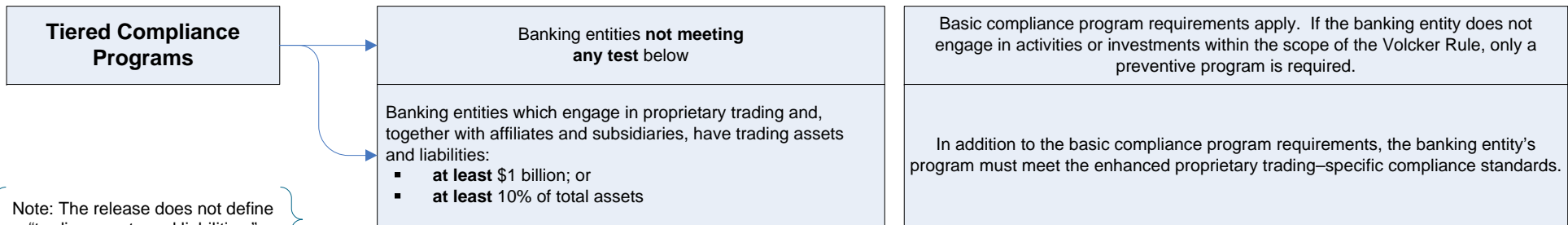
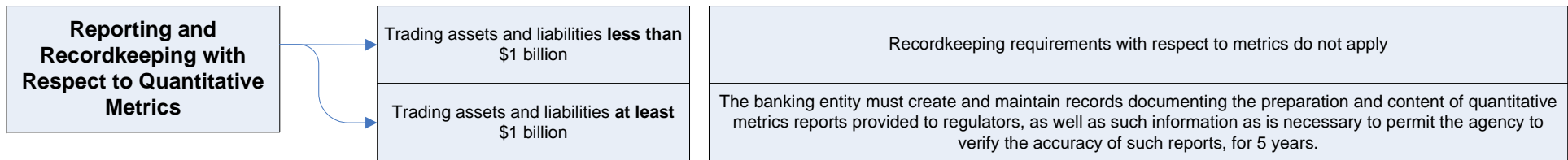
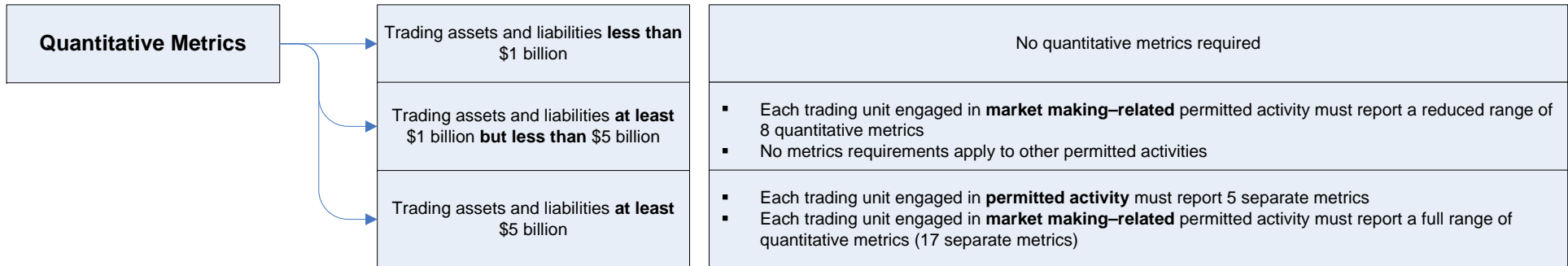
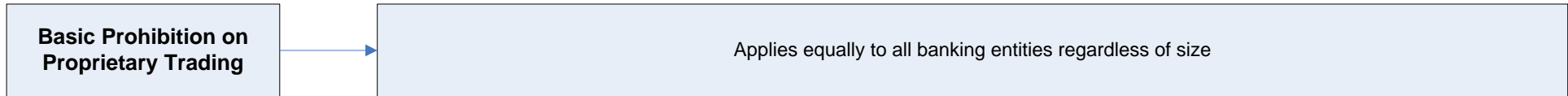
**TRAINING**

- For trading personnel, managers, and other appropriate personnel as determined by the banking entity
- May be conducted internally or by independent parties

4

**INDEPENDENT TESTING**

- Test overall program adequacy and effectiveness
- At a frequency appropriate to size and risk profile, and at least once every 12 months
- Testing party must be qualified and independent but may be internal or external
- Appropriate action must be taken to remedy any deficiencies



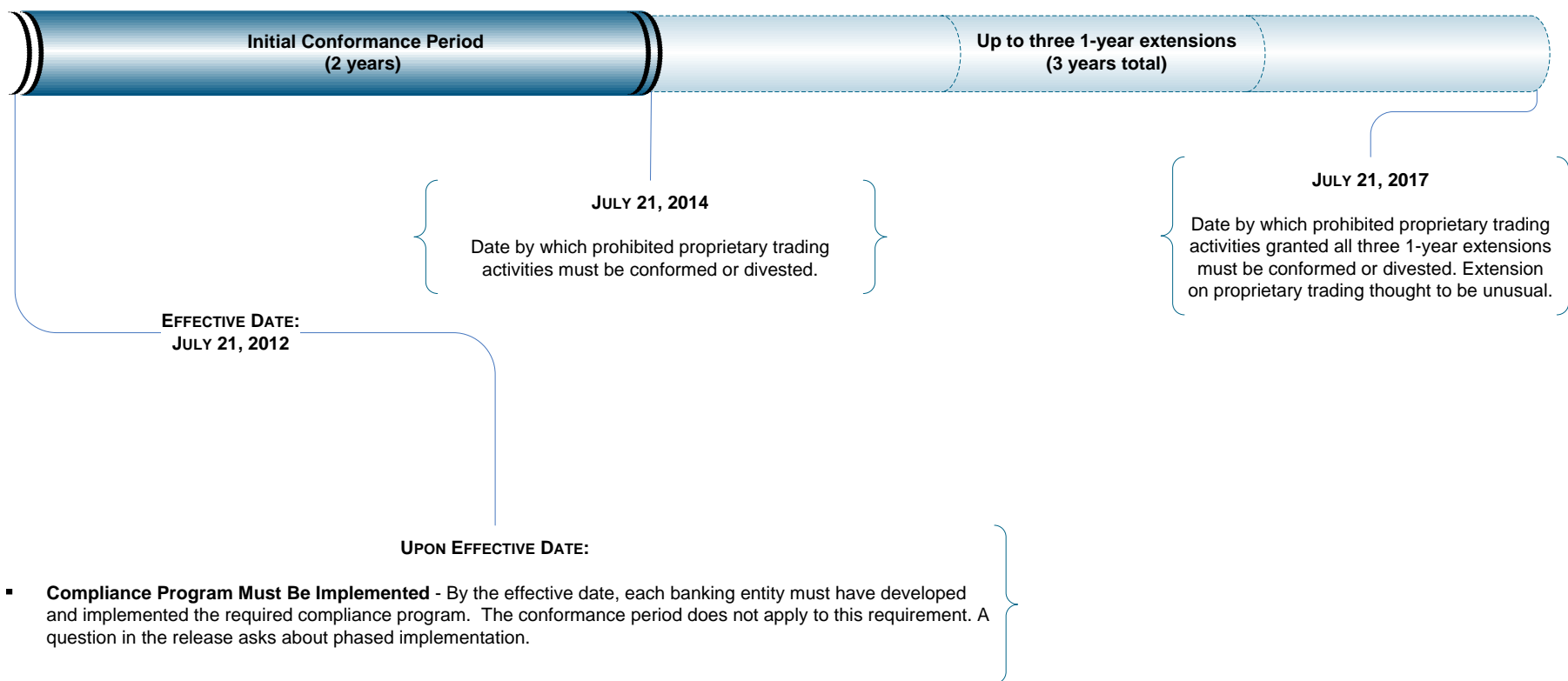
Note: The release does not define "trading assets and liabilities."



- **Applies to all covered trading activities.** Initial 2-year conformance period plus up to three 1-year extensions available for any covered activity commenced prior to July 21, 2012.
- **Conformance rules unchanged since final rulemaking.** Proposed rules implementing the Volcker Rule simply incorporate the February, 2011 final conformance rules with non-substantive conforming and technical changes. Proposed rules seek comment on whether the conformance rules should be revised in light of the content of the proposed rules
- **New banking entities.** A company that was not a banking entity, or a subsidiary or affiliate of a banking entity, as of July 21, 2010 and becomes a banking entity, or subsidiary or affiliate of a banking entity, must bring its activities into compliance with the Volcker Rule within two years after the date on which the company becomes a banking entity or a subsidiary or affiliate of a banking entity.
- **Extensions granted separately, run consecutively.** Banking entities must apply separately for each extension, at least 180 days prior to the expiration of the 2-year initial conformance period or any subsequent extension period.

**CONSULTATION BY THE FEDERAL RESERVE**

- The Federal Reserve is responsible for granting any extensions for the conformance period, regardless of the primary financial regulatory authority of the banking entity.
- Before granting an extension or imposing any restrictions on activities during any extension period, the Federal Reserve must consult with the FDIC, OCC, SEC or CFTC if such agency is the banking entity's primary financial regulatory authority.





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.

<b>Robert L. D. Colby</b>	202 962 7121	<a href="mailto:robert.colby@davispolk.com">robert.colby@davispolk.com</a>
<b>Annette L. Nazareth</b>	202 962 7075	<a href="mailto:annette.nazareth@davispolk.com">annette.nazareth@davispolk.com</a>
<b>Margaret E. Tahyar</b>	212 450 4379	<a href="mailto:margaret.tahyar@davispolk.com">margaret.tahyar@davispolk.com</a>
<b>Thomas J. Clarke</b>	33 1 56 59 36 56	<a href="mailto:thomas.clarke@davispolk.com">thomas.clarke@davispolk.com</a>
<b>E. Ashley Harris</b>	212 450 4780	<a href="mailto:ashley.harris@davispolk.com">ashley.harris@davispolk.com</a>
<b>Gabriel D. Rosenberg</b>	212 450 4537	<a href="mailto:gabriel.rosenberg@davispolk.com">gabriel.rosenberg@davispolk.com</a>