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Volcker Rule Proposed Regulations: Proprietary Trading

www.volckerrule.com

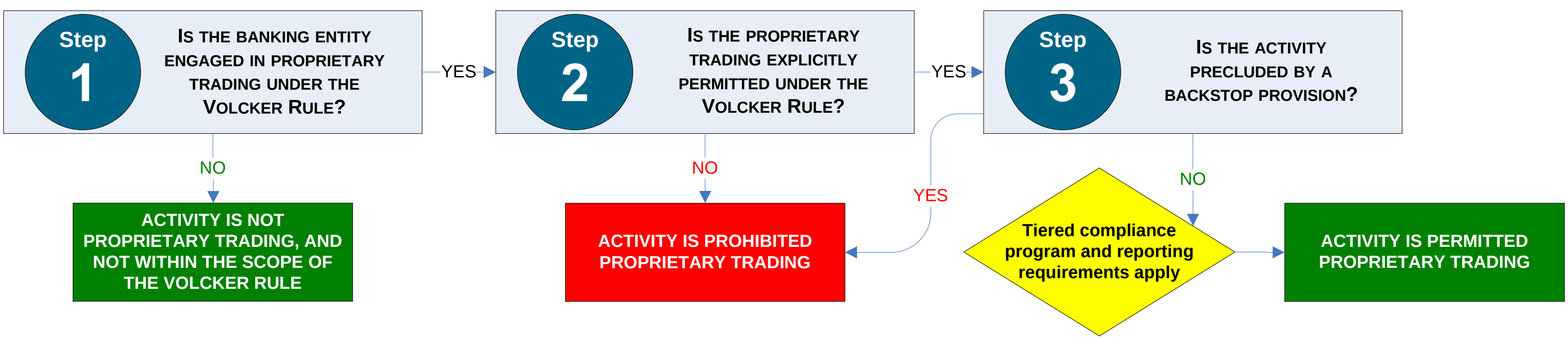
October 12, 2011

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, which is part of the Davis Polk Portal.



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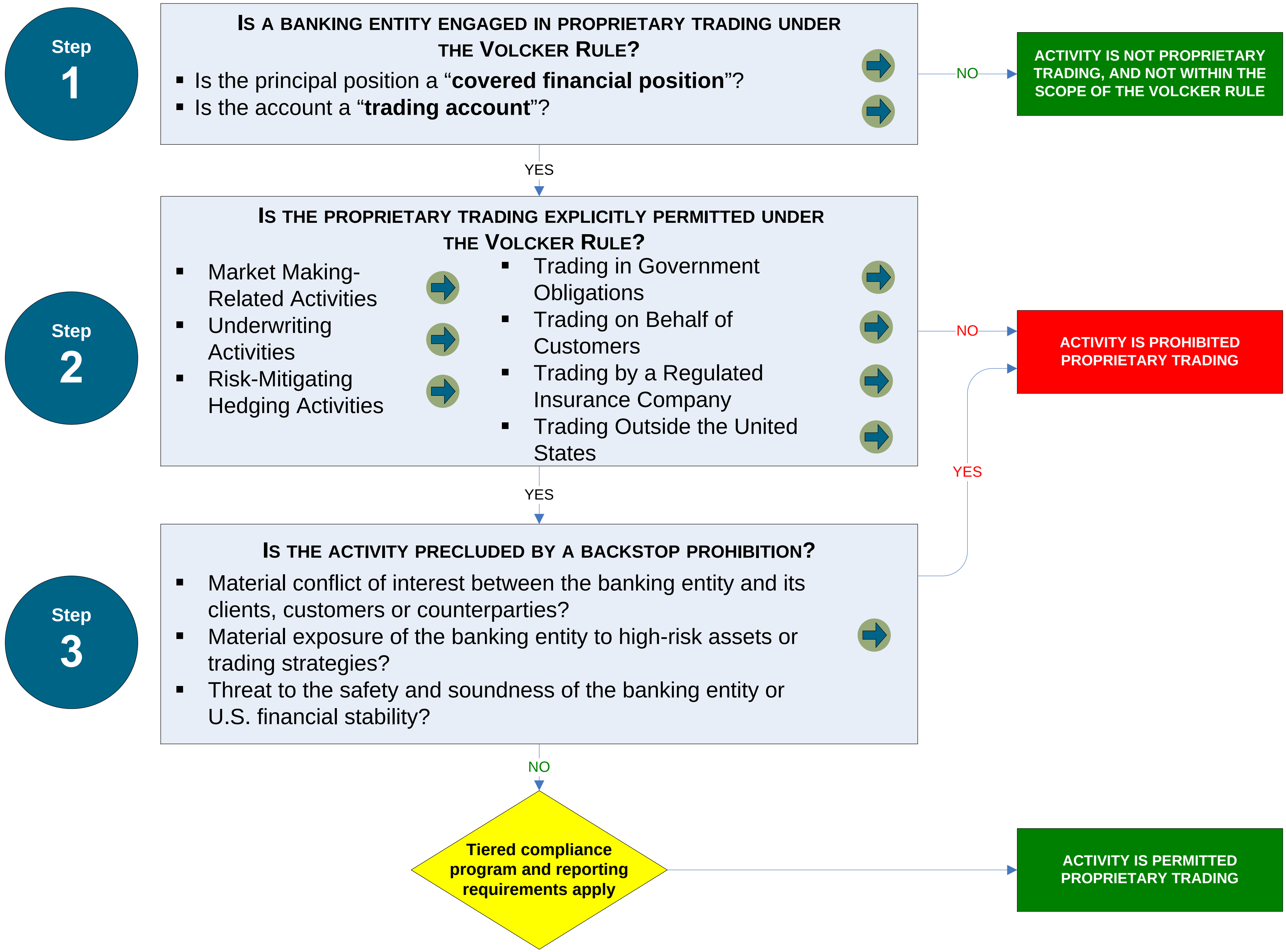
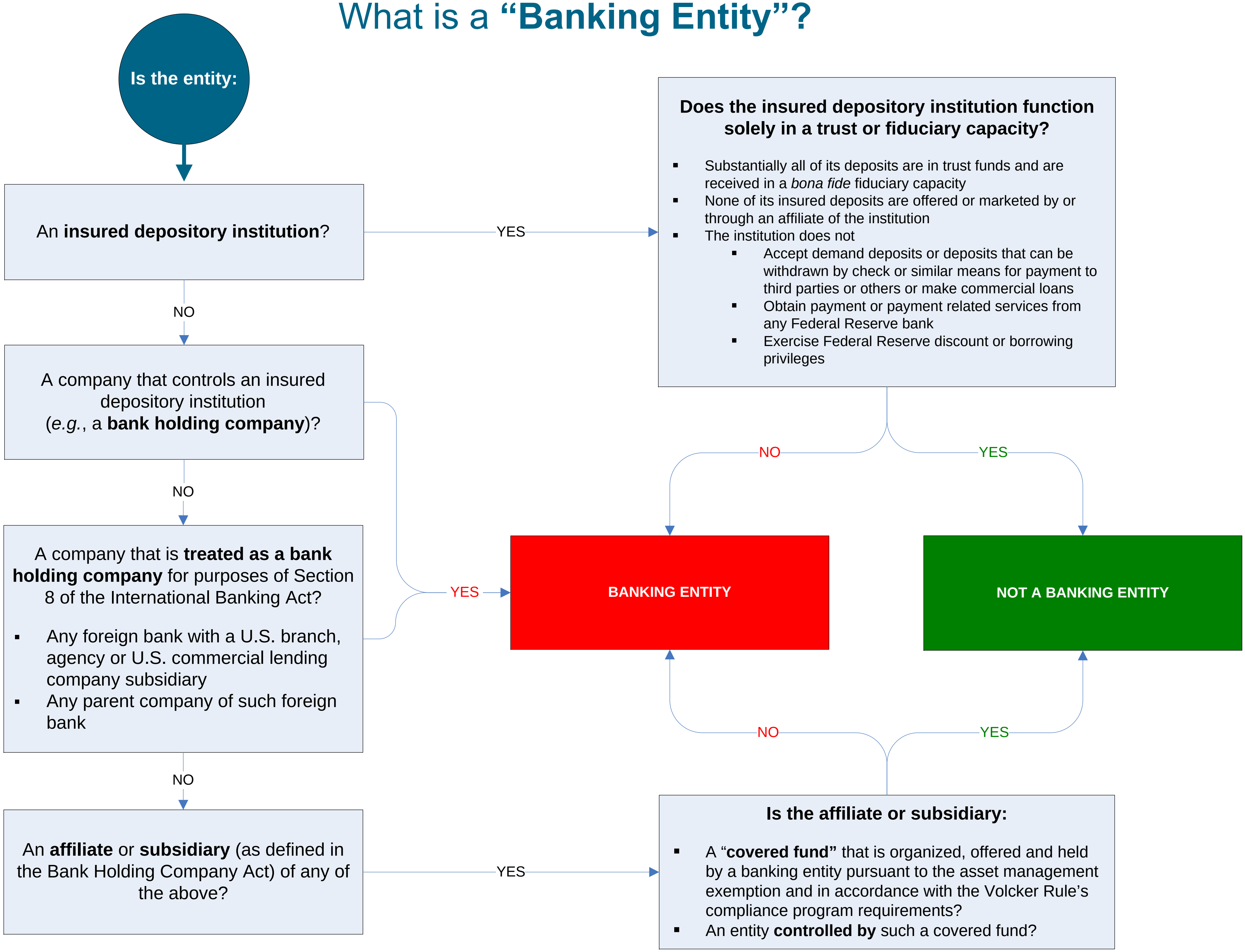
Volcker Rule — Proprietary Trading



Step 1:
What is a “Banking Entity”?



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Step 1:
Is It a Principal "**Covered Financial Position**"?

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**.

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

NO →

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.

NO → **ACTIVITY IS NOT PROPRIETARY TRADING, AND NOT WITHIN THE SCOPE OF THE VOLCKER RULE**

YES → **Position is a "covered financial position." Go to next page.**

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Step 1:
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

YES TO **ANY** QUESTION → **ACTIVITY IS NOT PROPRIETARY TRADING, AND IS NOT WITHIN THE SCOPE OF THE VOLCKER RULE**

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)?

NO TO **ALL THREE** QUESTIONS → **ACTIVITY IS NOT PROPRIETARY TRADING, AND IS NOT WITHIN THE SCOPE OF THE VOLCKER RULE**

YES TO **ANY** QUESTION → **The trading activity is proprietary trading within the scope of the Volcker Rule. Go to Step 2.**

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Step 2A: Permitted Activities: Market Making

Is the activity market making?

Does the trading desk "**hold itself out as being willing to buy or sell**, including through entering into long and short positions in, the covered financial position for its own account on a regular or continuous basis"?

In connection with this requirement, compliance with regulatory guidance on market making is also required. See the following slides for more detail.

YES

With respect to the covered financial position, are the desk's market making-related activities designed not to exceed the "**reasonably expected near term demands of clients**, customers or counterparties"?

YES

Are the desk's market making-related activities **designed to generate revenues primarily from fees, commissions, bid-ask spreads or other income __not attributable__** to:

- Appreciation in the value of covered financial positions it holds in trading accounts; or
- Hedging of covered financial positions it holds in trading accounts

YES

Are the **compensation arrangements of persons** performing the activities designed to reward proprietary risk-taking?

NO

NO

NO

YES

NO

IS THE LEGAL ENTITY ENGAGING IN THE ACTIVITY REGISTERED AS A DEALER OR EXEMPT?

1. **With respect to securities:**
   - An SEC-registered dealer, or a person exempt from registration or excluded from regulation as a dealer, such as a bank dealer exempt pursuant to Securities Exchange Act Section 3(a)(5)(C); OR
   - Engaged in the business of a dealer outside the U.S., subject to substantive regulation of such business in the jurisdiction where located, and conducting the purchase or sale outside of the U.S.
2. **With respect to swaps:**
   - A CFTC-registered swap dealer or a person exempt from registration; OR
   - Subject to substantive regulation of dealing outside the U.S. (see (1) above)
3. **With respect to security-based swaps:**
   - An SEC-registered swap dealer or a person exempt from registration; OR
   - Subject to substantive regulation of dealing outside the U.S. (see (1) above)
4. **With respect to municipal securities**, an SEC-registered municipal securities dealer or a person exempt from registration
5. **With respect to government securities**, a registered government securities dealer (or dealer that has filed notice under Section 15C of the Securities Exchange Act), or exempt from registration

NO

ACTIVITY IS __NOT__ A PERMITTED MARKET MAKING ACTIVITY

YES

Tiered compliance program and reporting required. See Appendices A, B and C

IF PROGRAM NOT ESTABLISHED AND MAINTAINED

Activity may be a permitted market making activity. Go to Step 3.

MARKET MAKING–RELATED HEDGING

A purchase or sale of a covered financial position may also be a permitted activity if:

- The covered financial position is purchased or sold to reduce the specific risk to the banking entity in connection with, and related to, individual aggregated positions, contracts or other holdings **acquired pursuant to** permitted market making–related activity
- The purchase or sale meets the requirements for permitted hedging activity **__See Step 2C__**

(SEE STEP 2C)

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Step 2A:
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:

Generally:

- **Passively providing liquidity** in a security on an **organized trading facility or exchange** by submitting resting orders that interact with the orders of others; OR
  - Must be a **registered market maker** where such exchange or organized trading facility provides the ability to register as a market maker
  - Must **primarily provide liquidity** rather than take liquidity on the exchange or trading facility
- Providing an **intermediation service** to its customers by assuming the role of a counterparty that stands ready to buy or sell a position that the customer wishes to sell or buy

In **liquid markets** such as equity securities and other exchange traded securities, this should generally include:

- Making **continuous two sided quotes** and holding oneself out to buy and sell on a continuous basis
- Pattern of trading that includes **purchase and sales** in **roughly comparable** amounts to provide liquidity
- Making continuous quotations at or near the market on both sides
- Providing widely accessible and broadly disseminated quotes

In **less liquid markets**, such as over-the-counter markets for debt and equity securities or derivatives, this should generally include:

- Holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not **necessarily continuous**) basis
- With respect to securities, regularly purchasing covered financial positions from, or selling the positions to, clients, customers, or counterparties in the **secondary market**
- Transaction **volumes and risk proportionate to historical** customer liquidity and investments needs

In **derivatives**:

- Market making may involve **entering into a derivative contract and hedging the incremental risk** from the contract, as opposed to buying and selling the contract

- Only the **market making unit** can rely on the market making exemption
- **Block positioning** constitutes market making. While undefined in the rule, block positioning may be informed by Securities Exchange Act Rule 3b-8, which includes the concept that the block cannot be sold on equivalent terms without a principal transaction
- Market making includes taking positions in **anticipation of customer demand**

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

Risk Management → Source of Revenues → Revenues Relative to Risk → Customer-Facing Activity → Payment of Fees, Commissions and Spreads → Compensation Incentives

See the following slides for more detail.

Step 2A:
Principles Distinguishing Market Making from Prohibited Proprietary Trading

Permitted Market Making	Principles	Prohibited Proprietary Trading
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 off the size and type required for market making.	**Risk Management**	A prop trader **retains risk exceeding** the size and type required to provide **intermediation** services to customers.
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.	**Source of Revenues**	A prop trader **primarily generates revenues from price movements** in retained principal positions/risks, rather than customer revenues.
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.	**Revenues Relative to Risk**	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 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.	**Customer-Facing Activity**	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**.
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.	**Payment of Fees, Commissions and Spreads**	A prop trader **routinely pays rather than earns fees, commissions or spreads**.
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**.	**Compensation Incentives**	A prop trader provides employee compensation incentives that primarily **reward proprietary risk taking**.

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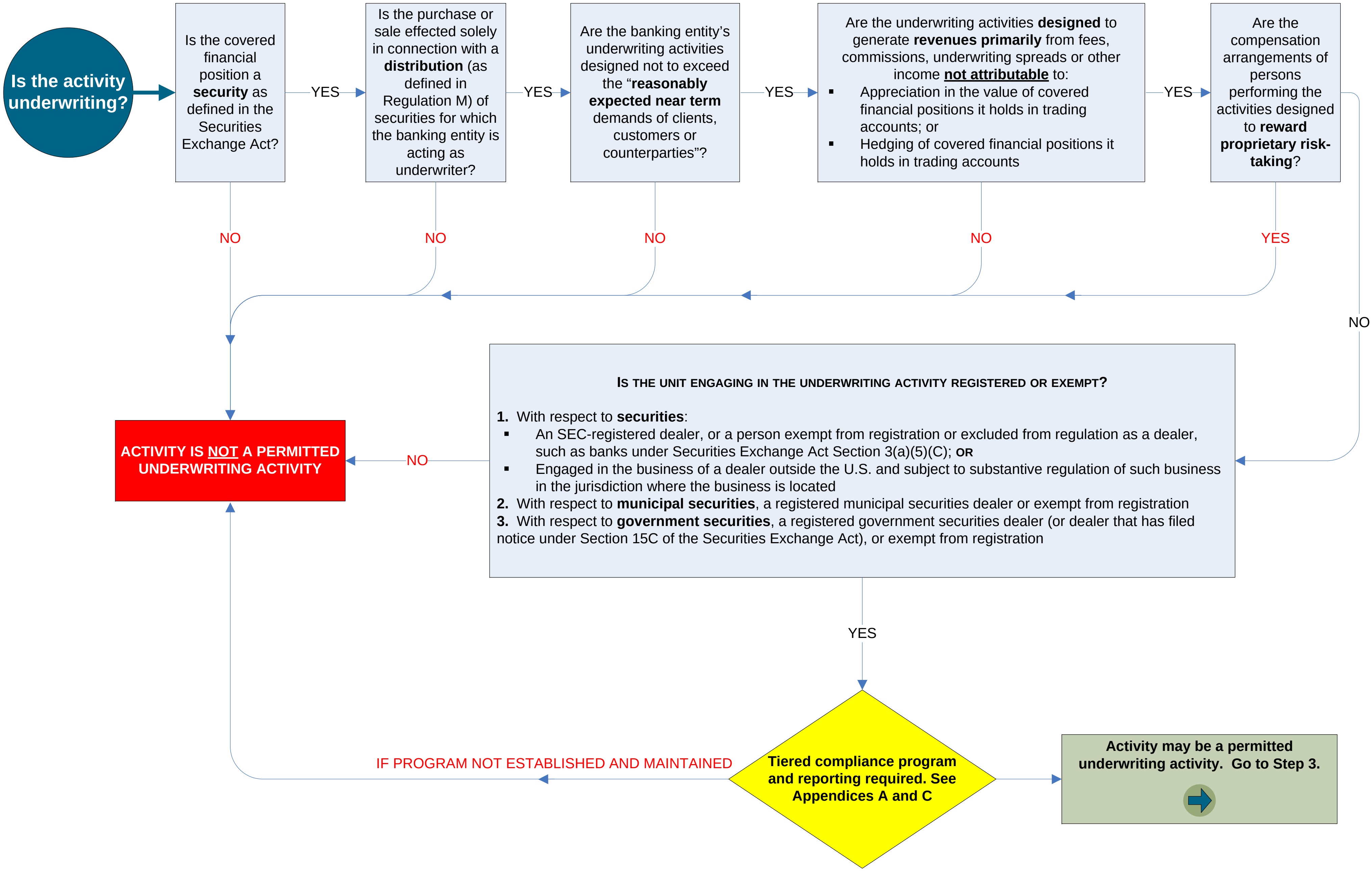
Step 2B:
Permitted Activities: Underwriting



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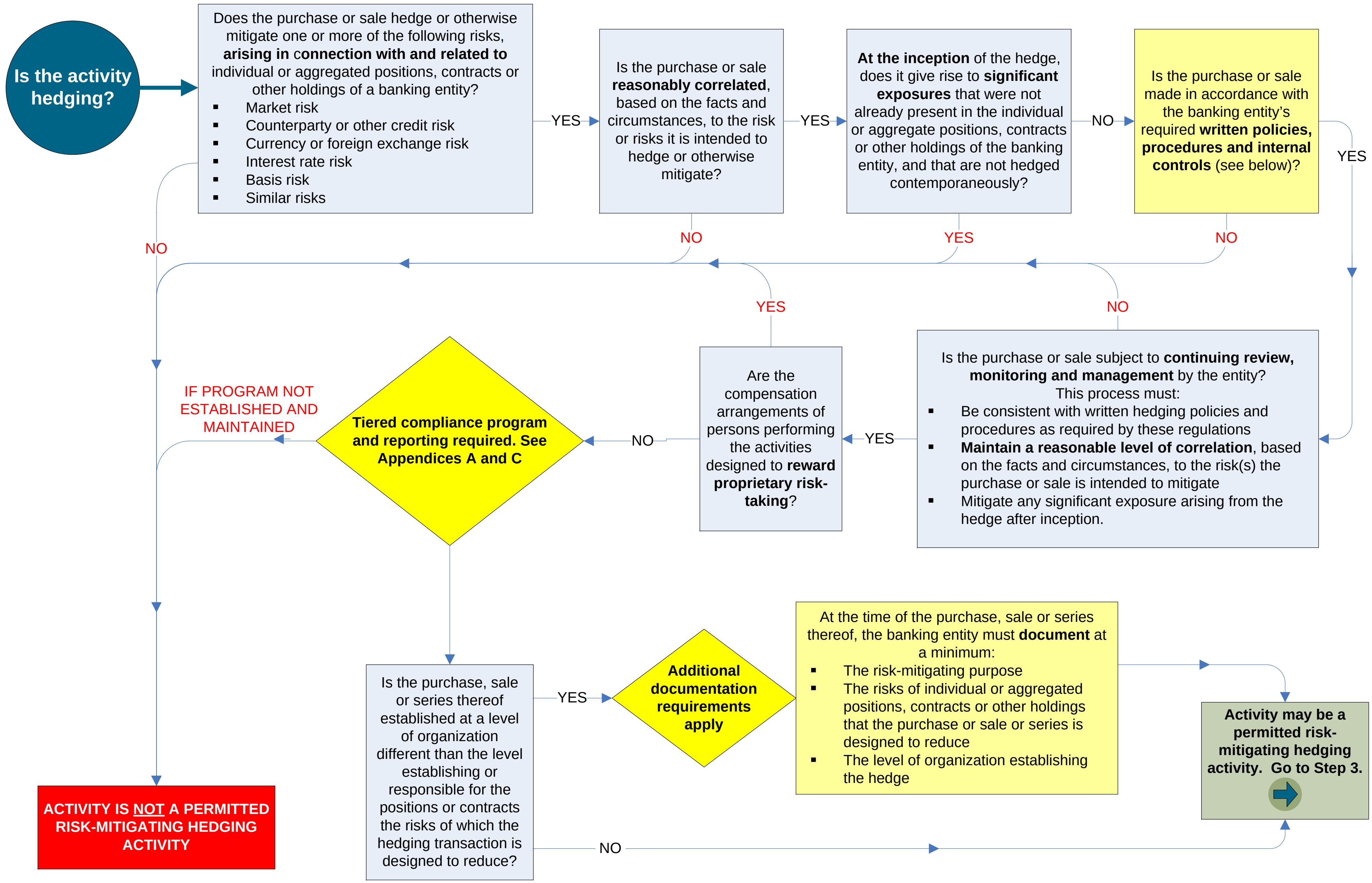
Step 2C:
Permitted Activities: Risk-Mitigating Hedging



Step 2D:
Permitted Activities: Government Obligations

Is the covered financial position a permitted government obligation?

Does the purchase or sale involve an obligation of the United States or any agency thereof?

OR

Does the purchase or sale involve an obligation, participation or other instrument of, or issued by, any of the following?

- Government National Mortgage Association (GNMA, Ginnie Mae)
- Federal National Mortgage Association (FNMA, Fannie Mae)
- Federal Home Loan Mortgage Corporation (FHLMC, Freddie Mac)
- A Federal Home Loan Bank (FHLB)
- Federal Agricultural Mortgage Corporation (FAMC, Farmer Mac)
- A Farm Credit System institution chartered under and subject to the Farm Credit Act of 1971

OR

Does the purchase or sale involve an obligation of any U.S. state or any political subdivision thereof, such as municipal bonds?

Each category includes both general obligations and limited obligations, such as revenue bonds

YES TO <u>**ANY**</u> QUESTION

Activity may be a permitted government obligations activity. Go to Step 3.

NO TO <u>**ALL THREE**</u> QUESTIONS

ACTIVITY IS <u>NOT</u> A PERMITTED GOVERNMENT OBLIGATIONS ACTIVITY

<u>**Non-U.S. Government Debt Is Not Eligible**</u>
Trading in E.U., Canadian or any other non-U.S. government debt does <u>**not**</u> qualify as a permitted government obligations activity, but a question in the release asks whether it should be.

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Step 2E:
Permitted Activities: On Behalf of Customers

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

Is the activity on behalf of customers?

Fiduciary Capacity

All of the following must apply:

- The banking entity is acting as **investment adviser**, **commodity trading advisor**, **trustee**, or in a similar **fiduciary capacity for a customer**
- The purchase or sale is conducted for the **account of the customer**
- The **customer alone is the beneficial owner** of the position involved in the transaction

OR

Riskless Principal

Is the banking entity acting as **riskless principal after receiving an order** to purchase or sell a covered financial position for a customer?

This requires that the offsetting purchase or sale be **contemporaneous**.

OR

Insurance Separate Account

Is the banking entity an insurance company that purchases or sells a covered financial position for a separate account? **All** of the following must apply:

- The insurance company is **directly engaged** in the business of insurance and **subject to regulation** by a state or foreign insurance regulator
- The insurance company purchases or sells **solely** for a separate account established by the insurance company in connection with one or more **insurance policies** issued by that insurance company
- **All profits and losses** are allocated to the **separate account** and inure to the benefit or detriment of the owners of the insurance policies supported by the account, and **not** to the insurance company
- The purchase or sale is conducted **in compliance with**, and subject to, the applicable **insurance legal requirements** regarding the insurance company

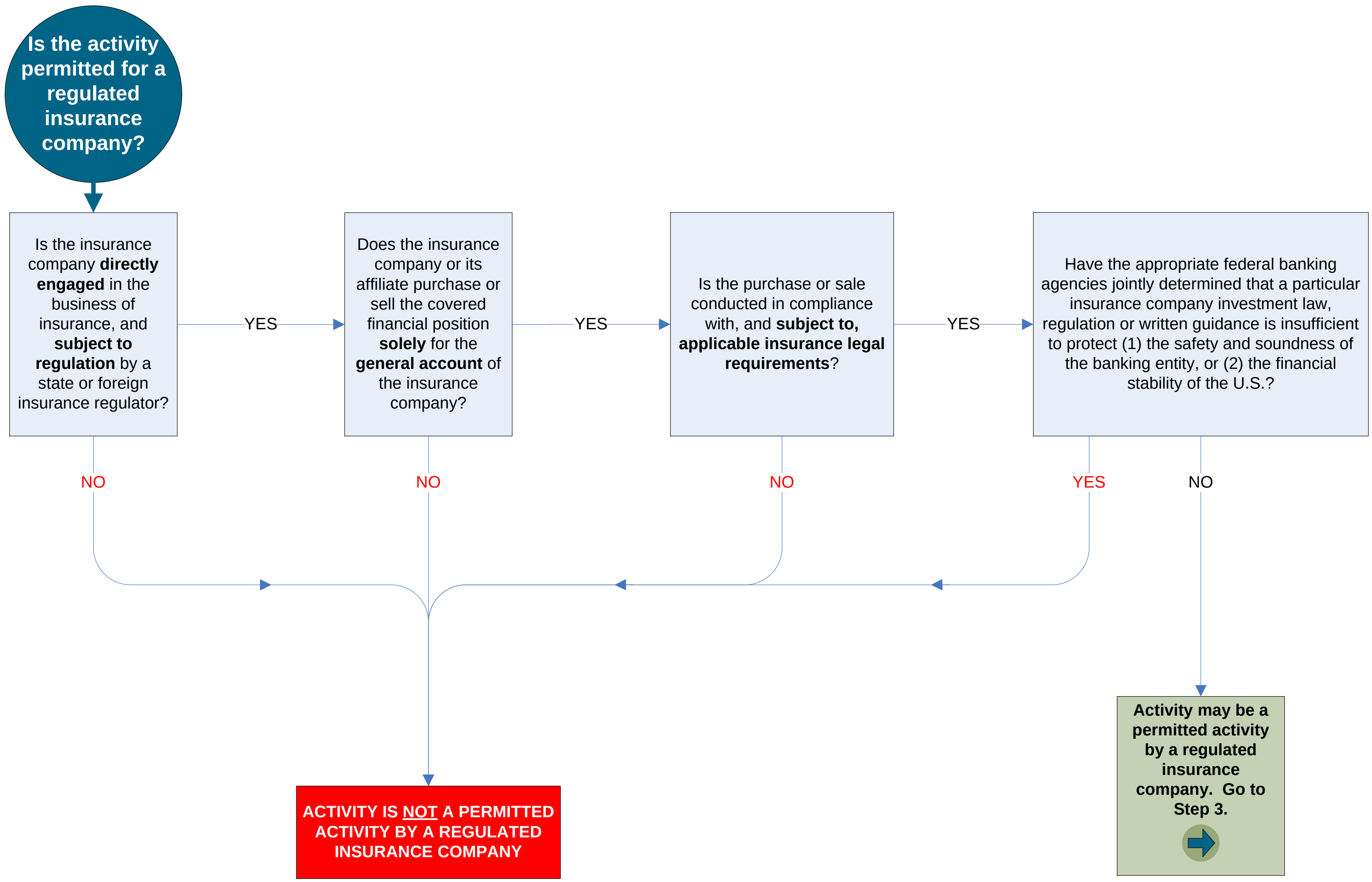
YES TO **ANY** QUESTION

Activity may be a permitted activity on behalf of customers. Go to Step 3.

NO TO **ALL THREE** QUESTIONS

ACTIVITY IS NOT A PERMITTED ACTIVITY ON BEHALF OF CUSTOMERS

Step 2F:
Permitted Activities: Regulated Insurance Companies



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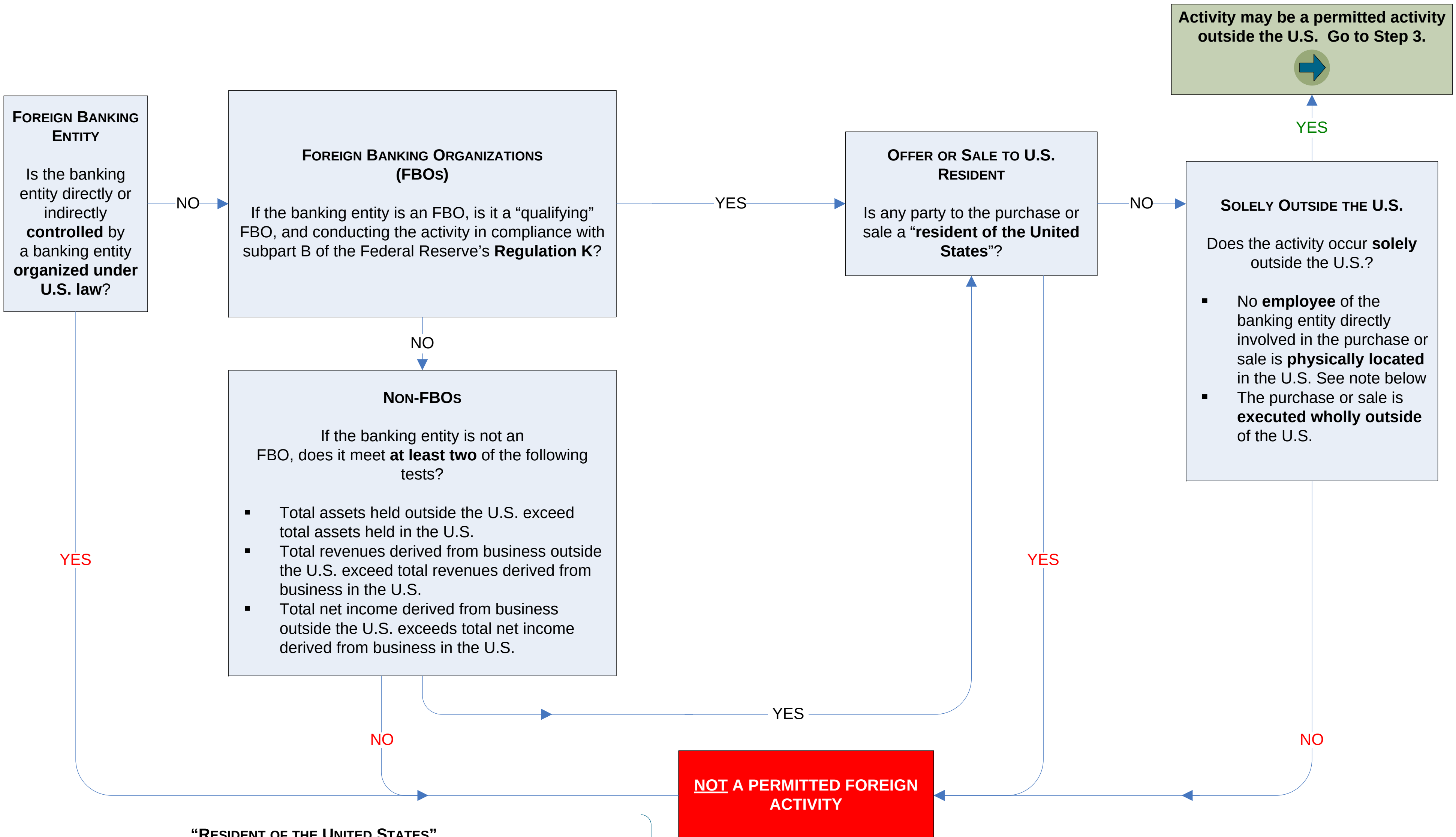
Step 2G:
Permitted Activities: Solely Outside the United States



“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.

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Step 3:
Is the Activity Precluded by a Backstop Prohibition?

Would the activity:

MATERIAL CONFLICTS OF INTEREST

Involve or result in the banking entity's interests **being materially adverse to the interests of its clients**, customers or counterparties?

YES → Exception 1 OR Exception 2

NO ↓

EXCEPTION 1
TIMELY AND EFFECTIVE DISCLOSURE AND OPPORTUNITY TO NEGATE/SUBSTANTIALLY MITIGATE

Before effecting the specific transaction or class or type of transactions, or engaging in the specific activity, for which a conflict may arise, does the banking entity:

- Make clear, timely, and effective disclosure of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest; and
- Make such disclosure explicitly and effectively, and in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on such party created by the conflict?

OR

EXCEPTION 2
INFORMATION BARRIERS

Has the banking entity established, maintained, and enforced **information barriers** that are memorialized in written policies and procedures, such as physical separation of personnel, or functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty?

Note that the banking entity **may not rely** on information barriers **if it knows or reasonably should known** that notwithstanding, the conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty

YES (to Exception 1 or Exception 2) → ACTIVITY IS PERMITTED

NO TO **BOTH** QUESTIONS → ACTIVITY IS PROHIBITED PROPRIETARY TRADING EVEN IF IT WOULD OTHERWISE QUALIFY AS A PERMITTED ACTIVITY

MATERIAL HIGH-RISK EXPOSURES

Result, directly or indirectly, in a **material exposure** by the covered banking entity to a **high-risk asset** or a **high-risk trading strategy**?

- "**High-risk asset**" means an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail
- "**High-risk trading strategy**" means a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail

YES → ACTIVITY IS PROHIBITED PROPRIETARY TRADING EVEN IF IT WOULD OTHERWISE QUALIFY AS A PERMITTED ACTIVITY

NO ↓

THREAT TO SAFETY AND SOUNDNESS

Pose a threat to the **safety and soundness** of the banking entity or the financial stability of the United States?

YES → ACTIVITY IS PROHIBITED PROPRIETARY TRADING EVEN IF IT WOULD OTHERWISE QUALIFY AS A PERMITTED ACTIVITY

NO ↓

ACTIVITY IS PERMITTED

Compliance Programs, Policies and Procedures

What compliance program requirement applies?

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

YES → **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

NO → **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 → **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

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

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

Compliance Programs, Policies and Procedures
Overview of Additional Program Requirements

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

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

5

Training

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

6

Recordkeeping

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

Tiered Compliance and Reporting by Size

Basic Prohibition on Proprietary Trading	Applies equally to all banking entities regardless of size	
Quantitative Metrics	Trading assets and liabilities **less than** $1 billion	No quantitative metrics required
	Trading assets and liabilities **at least** $1 billion **but less than** $5 billion	▪ Each trading unit engaged in **market making–related** permitted activity must report a reduced range of 8 quantitative metrics ▪ No metrics requirements apply to other permitted activities
	Trading assets and liabilities **at least** $5 billion	▪ Each trading unit engaged in **permitted activity** must report 5 separate metrics ▪ Each trading unit engaged in **market making–related** permitted activity must report a full range of quantitative metrics (17 separate metrics)
Reporting and Recordkeeping with Respect to Quantitative Metrics	Trading assets and liabilities **less than** $1 billion	Recordkeeping requirements with respect to metrics do not apply
	Trading assets and liabilities **at least** $1 billion	The banking entity must create and maintain records documenting the preparation and content of quantitative metrics reports provided to regulators, as well as such information as is necessary to permit the agency to verify the accuracy of such reports, for 5 years.
Tiered Compliance Programs	Banking entities **not meeting any test** below	Basic compliance program requirements apply. If the banking entity does not engage in activities or investments within the scope of the Volcker Rule, only a preventive program is required.
	Banking entities which engage in proprietary trading and, together with affiliates and subsidiaries, have trading assets and liabilities: ▪ **at least** $1 billion; or ▪ **at least** 10% of total assets	In addition to the basic compliance program requirements, the banking entity's program must meet the enhanced proprietary trading–specific compliance standards.

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

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Conformance Period

- **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.

Initial Conformance Period
(2 years)

Up to three 1-year extensions
(3 years total)

July 21, 2014

Date by which prohibited proprietary trading activities must be conformed or divested.

July 21, 2017

Date by which prohibited proprietary trading activities granted all three 1-year extensions must be conformed or divested. Extension on proprietary trading thought to be unusual.

Effective Date:
July 21, 2012

Upon Effective Date:

- **Compliance Program Must Be Implemented** - By the effective date, each banking entity must have developed and implemented the required compliance program. The conformance period does not apply to this requirement. A question in the release asks about phased implementation.

Questions?

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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