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.
Volcker Rule — Proprietary Trading

**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"?

**Activity is not proprietary trading, and not within the scope of the Volcker Rule**

**Step 2**

**Is the proprietary trading explicitly permitted under the Volcker Rule?**
- Market Making-Related Activities
- Underwriting Activities
- Risk-Mitigating Hedging Activities
- Trading in Government Obligations
- Trading on Behalf of Customers
- Trading by a Regulated Insurance Company
- Trading Outside the United States

**Activity is prohibited proprietary trading**

**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?

**Tiered compliance program and reporting requirements apply**

**Activity is permitted proprietary trading**
Step 1: What is a “Banking Entity”? 

Is the entity: 

- An insured depository institution? YES
- A company that controls an insured depository institution (e.g., a bank holding company)? NO
- A company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act? NO
- An affiliate or subsidiary (as defined in the Bank Holding Company Act) of any of the above? NO

Does the insured depository institution function solely in a trust or fiduciary capacity? 
- Substantially all of its deposits are in trust funds and are received in a bona fide fiduciary capacity
- None of its insured deposits are offered or marketed by or through an affiliate of the institution
- The institution does not 
  - Accept demand deposits or deposits that can be withdrawn by check or similar means for payment to third parties or others or make commercial loans
  - Obtain payment or payment related services from any Federal Reserve bank
  - Exercise Federal Reserve discount or borrowing privileges

Is the affiliate or subsidiary: 
- A “covered fund” that is organized, offered and held by a banking entity pursuant to the asset management exemption and in accordance with the Volcker Rule’s compliance program requirements?
- An entity controlled by such a covered fund?
Step 1: Is It a Principal “Covered Financial Position”?

Is the position a “covered financial position”?

- 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.

Is the principal 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.

Activity is not proprietary trading, and not within the scope of the Volcker Rule.

Position is a “covered financial position.” Go to next page.
Step 1:
Is the Account a “Trading Account”?

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, benefiting 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

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
- Benefiting 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

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.

Activity is not proprietary trading, and is not within the scope of the Volcker Rule

Activity is not proprietary trading, and is not within the scope of the Volcker Rule

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)?

The trading activity is proprietary trading within the scope of the Volcker Rule. Go to Step 2.
Step 2A: Permitted Activities: Market Making

Is the activity market making?

Yes

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”?

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?

Yes

Activity may be a permitted market making activity.

Go to Step 3.

No

Activity is not a permitted market making activity.

No

Is the legal entity engaging in the activity registered as a dealer or exempt?

No

Yes

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.

Yes

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)

Yes

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)

Yes

With respect to municipal securities, an SEC-registered municipal securities dealer or a person exempt from registration

Yes

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

Yes

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

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

Activity may be a permitted market making activity.

Go to Step 3.

No

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

See the following slides for more detail.
Step 2A: 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 or 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 or 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.

**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 or 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.
Step 2B: Permitted Activities: Underwriting

Is the activity underwriting?

- YES: Is the covered financial position a security as defined in the Securities Exchange Act?
- NO: ACTIVITY IS NOT A PERMITTED UNDERWRITING ACTIVITY

If NO, go to Step 2B.

If YES, Is the purchase or sale effected solely in connection with a distribution (as defined in Regulation M) of securities for which the banking entity is acting as underwriter?

- YES: Are the banking entity’s underwriting activities designed not to exceed the “reasonably expected near term demands of clients, customers or counterparties”?
- NO: Are the underwriting activities designed to generate revenues primarily from fees, commissions, underwriting 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

If YES, go to Step 2B.

If NO, go to Step 2B.

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

- YES: Activity may be a permitted underwriting activity. Go to Step 3.
- NO: Tiered compliance program and reporting required. See Appendices A and C

Is the unit engaging in the underwriting activity registered 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 banks under Securities Exchange Act Section 3(a)(5)(C); or
   - Engaged in the business of a dealer outside the U.S. and subject to substantive regulation of such business in the jurisdiction where the business is located
2. With respect to municipal securities, a registered government securities dealer (or dealer that has filed notice under Section 15C of the Securities Exchange Act), or exempt from registration

If NO, go to Step 2B.

If YES, go to Step 2B.
Step 2C: Permitted Activities: Risk-Mitigating Hedging

Does the purchase or sale hedge or otherwise mitigate one or more of the following risks, arising in connection with and related to individual or aggregated positions, contracts or other holdings of a banking entity?
- Market risk
- Counterparty or other credit risk
- Currency or foreign exchange risk
- Interest rate risk
- Basis risk
- Similar risks

Is the purchase or sale reasonably correlated, based on the facts and circumstances, to the risk or risks it is intended to hedge or otherwise mitigate?

At the inception of the hedge, does it give rise to significant exposures that were not already present in the individual or aggregate positions, contracts or other holdings of the banking entity, and that are not hedged contemporaneously?

Is the purchase or sale made in accordance with the banking entity’s required written policies, procedures and internal controls (see below)?

- Does the purchase or sale hedge or otherwise mitigate one or more of the following risks, arising in connection with and related to individual or aggregated positions, contracts or other holdings of a banking entity?
- Market risk
- Counterparty or other credit risk
- Currency or foreign exchange risk
- Interest rate risk
- Basis risk
- Similar risks

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

- Tiered compliance program and reporting required. See Appendices A and C

- Is the purchase, sale or series thereof established at a level of organization different than the level establishing or responsible for the positions or contracts the risks of which the hedging transaction is designed to reduce?

- Additional documentation requirements apply

- Activity may be a permitted risk-mitigating hedging activity. Go to Step 3.

- Activity is not a permitted risk-mitigating hedging activity

- Activity is not a permitted risk-mitigating hedging activity

© 2011 Davis Polk & Wardwell LLP. All rights reserved. This presentation is not a full analysis of the matters presented and should not be relied upon as legal advice. volckerrule.com 9
Does the purchase or sale involve an obligation of the United States or any agency thereof?

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

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.

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

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

Activity is not a permitted government obligations activity.
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

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.

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

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

Activity is not a permitted activity on behalf of customers.

© 2011 Davis Polk & Wardwell LLP. All rights reserved. This presentation is not a full analysis of the matters presented and should not be relied upon as legal advice.
volckerrule.com
Step 2F: Permitted Activities: Regulated Insurance Companies

Is the activity permitted for a regulated insurance company?

Is the insurance company directly engaged in the business of insurance, and subject to regulation by a state or foreign insurance regulator?

YES

Does the insurance company or its affiliate purchase or sell the covered financial position solely for the general account of the insurance company?

YES

Is the purchase or sale conducted in compliance with, and subject to, applicable insurance legal requirements?

YES

Have the appropriate federal banking agencies jointly determined that a particular insurance company investment law, regulation or written guidance is insufficient to protect (1) the safety and soundness of the banking entity, or (2) the financial stability of the U.S.?

YES

Activity may be a permitted activity by a regulated insurance company. Go to Step 3.

NO

Activity is not a permitted activity by a regulated insurance company.

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO

NO
Step 2G: Permitted Activities: Solely Outside the United States

FOREIGN BANKING ENTITY
Is the banking entity directly or indirectly controlled by a banking entity organized under U.S. law?

FOREIGN BANKING ORGANIZATIONS (FBOs)
If the banking entity is an FBO, is it a “qualifying” FBO, and conducting the activity in compliance with subpart B of the Federal Reserve’s Regulation K?

OFFER OR SALE TO U.S. RESIDENT
Is any party to the purchase or sale a “resident of the United States”?

NON-FBOs
If the banking entity is not an FBO, does it meet at least two of the following tests?
- Total assets held outside the U.S. exceed total assets held in the U.S.
- Total revenues derived from business outside the U.S. exceed total revenues derived from business in the U.S.
- Total net income derived from business outside the U.S. exceeds total net income derived from business in the U.S.

FOREIGN BANKING ORGANIZATIONS (FBOS)
If the banking entity is an FBO, is it a “qualifying” FBO, and conducting the activity in compliance with subpart B of the Federal Reserve’s Regulation K?

SOLELY OUTSIDE THE U.S.
Does the activity occur solely outside the U.S.?
- No employee of the banking entity directly involved in the purchase or sale is physically located in the U.S. See note below
- The purchase or sale is executed wholly outside of the U.S.

NOT A PERMITTED FOREIGN ACTIVITY
Activity may be a permitted activity outside the U.S. Go to Step 3.

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.
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
- No

**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?
- Yes
- 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
- No

**Exception 1**
Timely and Effective Disclosure and Opportunity to Negate/Substantially Mitigate
Before effecting the specific transaction or class 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?
- Yes
- No

**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?
- Yes
- No

**ACTIVITY IS PERMITTED**

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

**NO TO BOTH QUESTIONS**
What compliance program requirement applies?

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

- NO
  - Preventive compliance program required

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

  - ADDITIONAL PROGRAM REQUIREMENTS**
    - 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

  - 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 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

** 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

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 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 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

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
## Tiered Compliance and Reporting by Size

### Basic Prohibition on Proprietary Trading
Applies equally to all banking entities regardless of size.

### Quantitative Metrics

<table>
<thead>
<tr>
<th>Trading assets and liabilities</th>
<th>Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $1 billion</td>
<td>No quantitative metrics required</td>
</tr>
</tbody>
</table>
| 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 |
| 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

<table>
<thead>
<tr>
<th>Trading assets and liabilities</th>
<th>Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $1 billion</td>
<td>Recordkeeping requirements with respect to metrics do not apply</td>
</tr>
<tr>
<td>At least $1 billion</td>
<td>- 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.</td>
</tr>
</tbody>
</table>

### Tiered Compliance Programs

<table>
<thead>
<tr>
<th>Banking entities not meeting any test below</th>
<th>Requirements</th>
</tr>
</thead>
</table>
| - at least $1 billion; or  
- at least 10% of total assets |
| Banking entities which engage in proprietary trading and, together with affiliates and subsidiaries, have trading assets and liabilities: | - 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.  
- 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.”
- **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.
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.

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