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Volcker Rule Proposed Regulations: Proprietary Trading

October 12, 2011

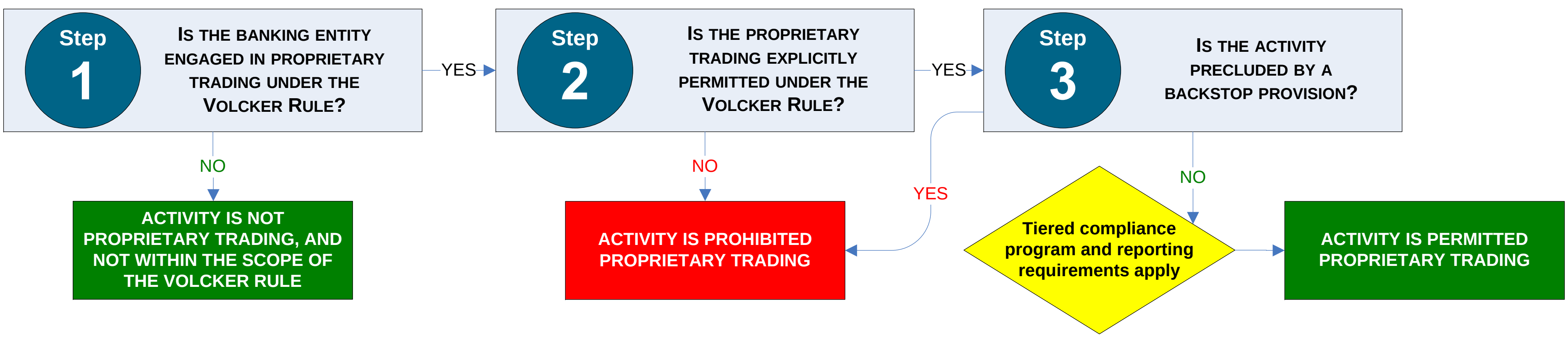
www.volckerrule.com

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**"?

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
- 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

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?

YES → **ACTIVITY IS PROHIBITED PROPRIETARY TRADING**

NO ↓

Tiered compliance program and reporting requirements apply

→ **ACTIVITY IS PERMITTED PROPRIETARY TRADING**

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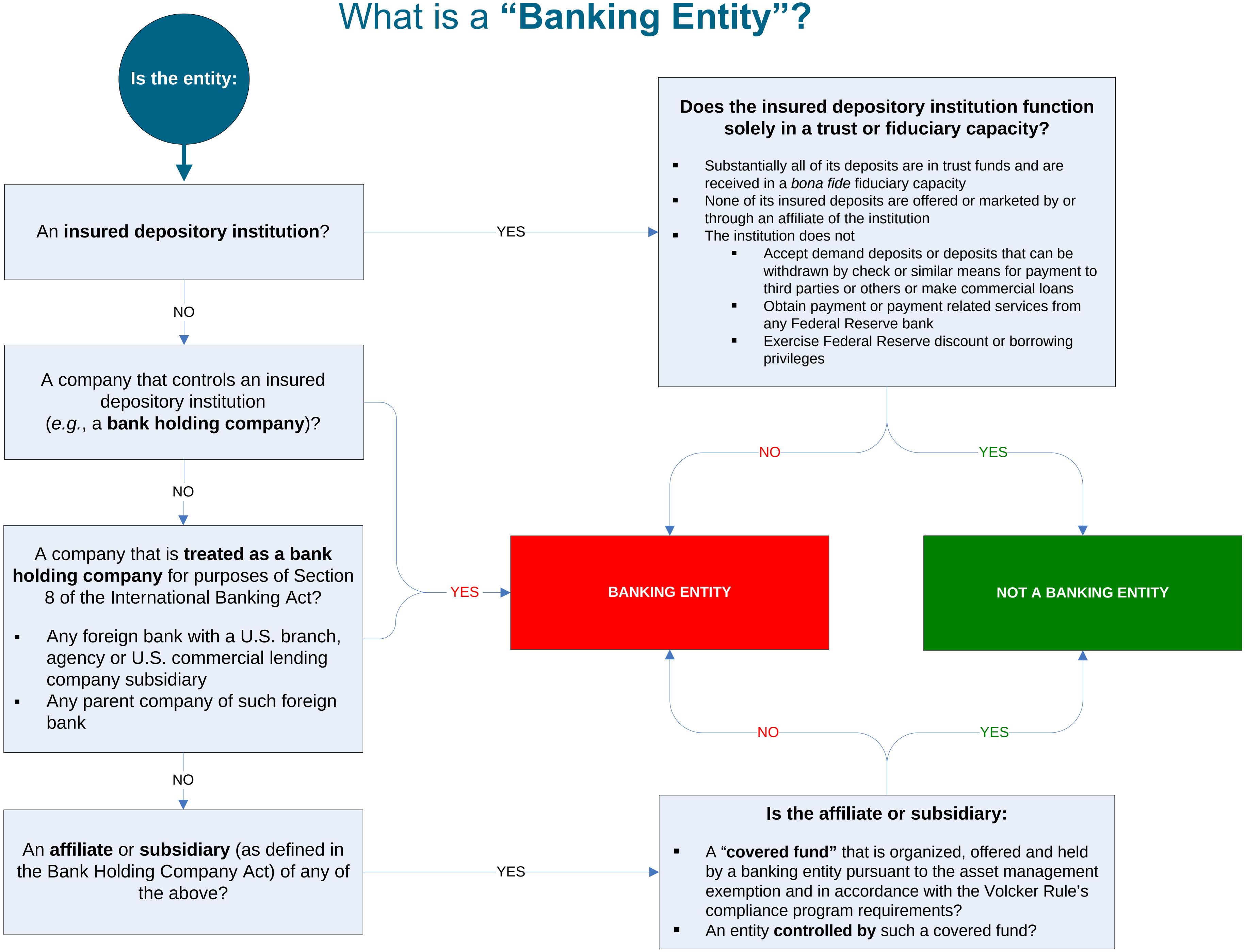
Step 1:
What is a “Banking Entity”?



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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.

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

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

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)

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 w**illing 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

Is the activity underwriting?

Is the covered financial position a **security** as defined in the Securities Exchange Act?

YES

NO

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

NO

Are the banking entity's underwriting activities designed not to exceed the "**reasonably expected near term** demands of clients, customers or counterparties"?

YES

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

YES

NO

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

YES

NO

ACTIVITY IS NOT A PERMITTED UNDERWRITING ACTIVITY

NO

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 municipal securities dealer or exempt from registration

3. 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

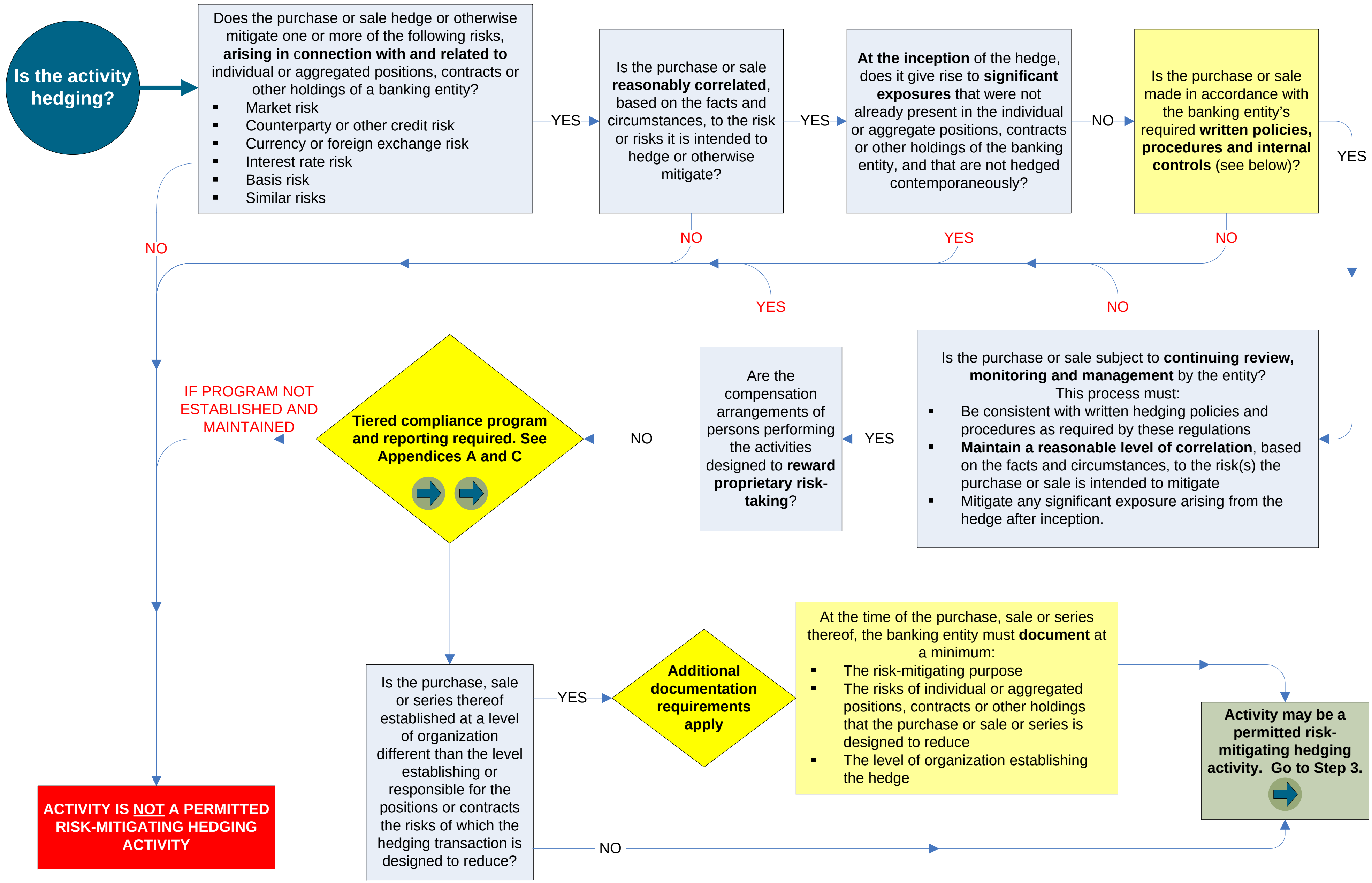
YES

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

IF PROGRAM NOT ESTABLISHED AND MAINTAINED

Activity may be a permitted underwriting activity. Go to Step 3.

Step 2C:
Permitted Activities: Risk-Mitigating Hedging



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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

NO TO **ALL THREE** QUESTIONS

YES TO **ANY** QUESTION

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

ACTIVITY IS NOT A PERMITTED GOVERNMENT OBLIGATIONS ACTIVITY

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.

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

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

YES TO <u>ANY</u> QUESTION

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

ACTIVITY IS <u>NOT</u> A PERMITTED ACTIVITY ON BEHALF OF CUSTOMERS

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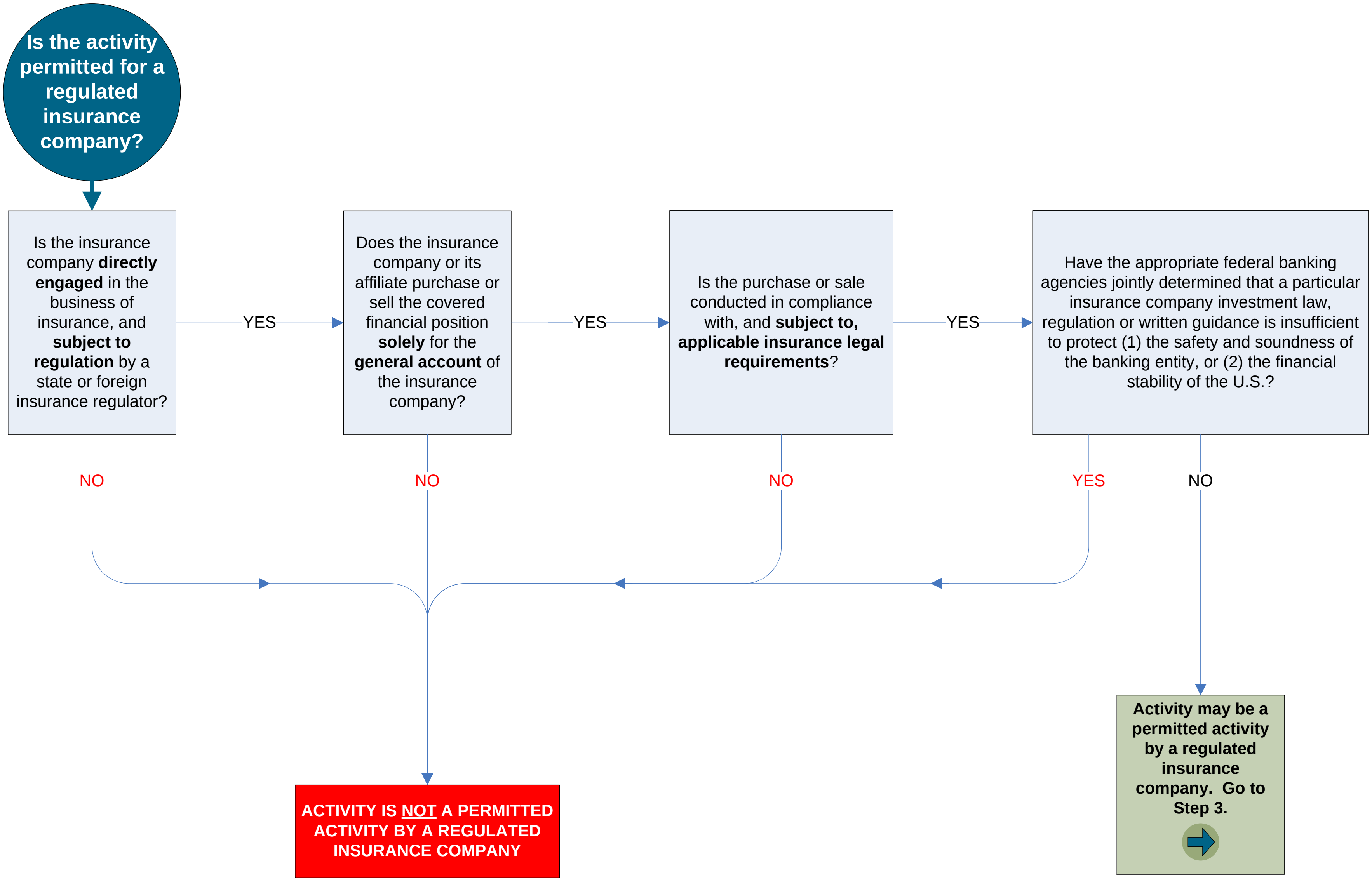
Step 2F:
Permitted Activities: Regulated Insurance Companies



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**?

YES → **NOT A PERMITTED FOREIGN ACTIVITY**

NO → Foreign Banking Organizations (FBOs)

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**?

YES → Offer or Sale to U.S. Resident

NO → Non-FBOs

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.

YES → Offer or Sale to U.S. Resident

NO → **NOT A PERMITTED FOREIGN ACTIVITY**

Offer or Sale to U.S. Resident

Is any party to the purchase or sale a "**resident of the United States**"?

YES → **NOT A PERMITTED FOREIGN ACTIVITY**

NO → Solely Outside the U.S.

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.

YES → **Activity may be a permitted activity outside the U.S. Go to Step 3.**

NO → **NOT A PERMITTED FOREIGN ACTIVITY**

<u>NOT</u> A PERMITTED FOREIGN ACTIVITY

"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

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**?

- "**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

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

ACTIVITY IS PERMITTED

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

NO TO **BOTH** QUESTIONS

YES

YES

YES

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

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."

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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Proprietary Trading Quantitative Reporting Requirements
Overview: Full List of Metrics by Category

Risk-Management Measurements	▪ VaR and SVaR or Stress VaR ▪ VaR Exceedance ▪ Risk Factor Sensitivities ▪ Risk and Position Limits
Source-of-Revenue Measurements	▪ Comprehensive Profit and Loss ▪ Portfolio Profit and Loss ▪ Fee Income and Expense ▪ Spread Profit and Loss ▪ Comprehensive Profit and Loss Attribution
Revenue-Relative-to-Risk Measurements	▪ Volatility of Comprehensive Profit and Loss and Volatility of Portfolio Profit and Loss ▪ Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio ▪ Unprofitable Trading Days Based on Comprehensive Profit and Loss and Unprofitable Trading Days Based on Portfolio Profit and Loss ▪ Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss
Customer-Facing Activity Measurements	▪ Inventory Risk Turnover ▪ Inventory Aging ▪ Customer-Facing Trade Ratio
Payment of Fees, Commissions and Spreads Measurement	▪ Pay-to-Receive Spread Ratio

Metrics Reporting for Covered Banking Entities with $5 Billion or More in Trading Assets and Liabilities

The following quantitative requirements apply to a banking entity if:

- The entity is engaged in **any** trading activity **within the scope** of the Volcker Rule
- On a **worldwide consolidated basis**, the average gross sum of trading assets and liabilities (as of the last day of each of the 4 prior calendar quarters) is **equal to or greater than $5 billion**

Each trading unit engaged in <u>permitted</u> trading activities must report:

- Comprehensive Profit and Loss
- Comprehensive Profit and Loss Attribution
- Value-at-Risk (VaR) and Stress VaR
- Risk Factor Sensitivities
- Risk and Position Limits

Each trading unit engaged in <u>permitted market making-related</u> activities must report:

- VaR and Stress VaR
- VaR Exceedance
- Risk Factor Sensitivities
- Risk and Position Limits
- Comprehensive Profit and Loss
- Portfolio Profit and Loss
- Fee Income and Expense
- Spread Profit and Loss
- Pay-to-Receive Spread Ratio
- Comprehensive Profit and Loss Attribution
- Unprofitable Trading Days Based on Comprehensive Profit and Loss, and Unprofitable Trading Days Based on Portfolio Profit and Loss
- Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss
- Volatility of Comprehensive Profit and Loss and Volatility of Portfolio Profit and Loss
- Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio
- Inventory Risk Turnover
- Inventory Aging
- Customer-Facing Trade Ratio

Frequency of Calculation: Each trading day
Frequency of Reporting: Monthly, reported within 30 days of the end of the month
Recordkeeping Requirement: 5 years

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Metrics Reporting for Covered Banking Entities with $1 Billion to $5 Billion in Trading Assets and Liabilities

The following quantitative requirements apply to a banking entity if:

- The entity is engaged in **any** trading activity **within the scope** of the Volcker Rule
- On a **worldwide consolidated** basis, the average gross sum of trading assets and liabilities (as of the last day of each of the 4 prior calendar quarters) is **at least $1 billion and less than $5 billion**

Each trading unit engaged in permitted market making-related activities must report:

- Comprehensive Profit and Loss
- Portfolio Profit and Loss
- Fee Income and Expense
- Spread Profit and Loss
- VaR
- Comprehensive Profit and Loss Attribution
- Volatility of Comprehensive Profit and Loss and Volatility of Portfolio Profit and Loss
- Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio

Frequency of Calculation: Each trading day
Frequency of Reporting: Monthly, reported within 30 days of the end of the month
Recordkeeping Requirement: 5 years

A. Risk-Management Measurements
1. Value-at-Risk ("VaR") and Stress VaR ("SVaR")

Description	VaR: common percentile measurement of the risk of future financial loss in the value of a given portfolio over a specified period of time, given current market conditions. SVaR: VaR based on market conditions during a period of significant financial stress.
Guidance	▪ Should reflect a loss in a trading unit that is expected to be exceeded less than 1% of the time over a one-day period ▪ Banking entities should compute and report VaR and SVaR consistently with federal regulatory capital requirements ▪ If a trading unit does not have a standalone VaR or SVaR calculation but is part of a larger portfolio which does, a standalone calculation should be performed consistent with existing methodology
Calculation Period	One trading day.

Description	For any given calculation period, the difference between VaR and Portfolio Profit and Loss (slide B.2), exclusive of Spread Profit and Loss (slide B.4) for a trading unit.
Calculation Period	One trading day.

A. Risk-Management Measures
3. Risk Factor Sensitivities

Description	Changes in a trading unit's Portfolio Profit and Loss (slide B.2), exclusive of Spread Profit and Loss (slide B.4) that are expected to occur in the event of a change in a trading unit's risk factors (underlying market variables that are significant sources of profitability and risk for the trading unit).

Guidance	▪ Should report the Risk Factor Sensitivities ("RFS") monitored and managed as part of the trading unit's risk management policy.
	  ▪ Underlying data and computation methods should depend on the trading unit's specific function and risk management models used. Number and type of RFS monitored, managed and reported should depend on the trading unit's explicit assumed risks
	  ▪ However, reported RFS should generally be sufficient to account for a preponderance of price variation in the trading unit's holdings
	▪ Trading units should take into account any relevant factors, including for example the following, in calculating RFS:
	  ▪ *Commodity derivative positions*: Sensitivities with respect to the type of commodity; maturity of positions; volatility and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities); maturity profile of positions
	  ▪ *Credit positions*: Sensitivities with respect to credit spread facts that are sufficiently granular to account for specific credit factors and market segments; maturity profile of positions; sensitivities to interest rates at all relevant maturities

Guidance *(cont.)*	▪ *Credit-related derivative positions*: Credit position sensitivities, volatility and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities); maturity profile of positions ▪ *Equity positions*: Sensitivity to equity prices; sensitivities that differentiate between important equity market sectors and segments (*e.g.*, small cap equities and international equities) ▪ *Equity derivative positions*: Equity position sensitivities, volatility and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities); maturity profile of positions ▪ *Foreign exchange derivative positions*: Sensitivities with respect to major currency pairs and maturities; sensitivity to interest rates at relevant maturities; volatility and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities); maturity profile of positions ▪ *Interest rate positions (including interest rate derivative positions)*: Sensitivities with respect to major interest rate categories and maturities; volatility and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities); maturity profile of positions ▪ Methods used to calculate sensitivities to a common factor shared by multiple trading units should be applied consistently across trading units to facilitate comparison.
Calculation Period	One trading day.

A. Risk-Management Measures
4. Risk and Position Limits

Description	The constraints set by the banking entity that define the amount of risk that a trading unit is permitted to take at a given point in time.
Guidance	▪ Should be reported in the format used by the banking entity for risk management purposes ▪ Often expressed in terms of risk measures such as VaR (slide A.1) and Risk Factor Sensitivities (slide A.3), but may also be expressed in terms of other observable criteria ▪ If criteria other than VaR or Risk Factor Sensitivities are used, both the value of the limits and the value of the variables used should be reported
Calculation Period	One trading day.

B. Source-of-Revenue Measurements
1. Comprehensive Profit and Loss

Description	Net profit or loss of a trading unit's material sources of trading revenue over a given period of time. Generally should equal the sum of the trading unit's: ▪ Portfolio Profit and Loss (slide B.2) ▪ Fee Income (slide B.3)
Guidance	Should be computed using data on the value of a trading unit's underlying holdings; prices at which the holdings were bought and sold; the value of fees, commissions, sales credits, spreads, dividends, interest income and expense; or other realized or unrealized sources of income from trading activities. Should not include compensation costs or other costs required to operate the unit (such as IT costs, internal reporting and management charges and adjustments such as accounting reserves).
Calculation Period	One trading day.

B. Source-of-Revenue Measures
2. Portfolio Profit and Loss

Description	Trading unit's net profit or loss on its underlying holdings over a specific period of time, whether unrealized or unrealized.
Guidance	▪ Should generally include any increase or decrease in the market value of a trading unit's holding (*e.g.*, any dividend, interest income or expense) ▪ Should not include direct fees, commissions, sales credits or other sources of trading revenue not directly related to the market value of holdings ▪ Generally should not include compensation costs or other costs required to operate the unit (such as IT costs, internal reporting and management charges and adjustments such as accounting reserves)
Calculation Period	One trading day

B. Source-of-Revenue Measures
3. Fee Income and Expense

Description	Generally includes direct fees, commissions and other distinct income for services provided by or to a trading unit over a specific period of time.
Guidance	▪ Should be calculated using data on direct fees earned by the trading unit for services it provides to clients, customers or counterparties—such as fees earned for structured transactions or sale commissions, and credits earned for fulfilling a customer request, whether realized or unrealized, and similar fees paid by the unit to other service providers
Calculation Period	One trading day.

Description	The portion of Portfolio Profit and Loss (slide B.2) that generally includes revenue generated by a trading unit from charging higher prices to buyers than it pays to sellers of comparable instruments over the same period of time.

Guidance	▪ Generally should be computed using data on prices at which comparable instruments are bought or sold by the trading unit, as well as turnover of such instruments
	▪ Should be measured with respect to both purchase and sale of a position, and should include:
	    ▪ Spreads earned by the trading unit for executing transactions (as a positive amount)
	    ▪ Spreads paid by the trading unit to initiate transaction (as a negative amount)
	▪ Should calculate the difference between the bid or ask price and the mid-market price (the average of bid and ask)
	▪ For market making-related activities in asset classes for which spreads are widely disseminated, constantly updated, and readily available, or otherwise reasonably ascertainable, the trading unit should use the prevailing bid-ask or similar spread on the relevant position at the time the purchase or sale is completed. In other asset classes, spreads may not be widely disseminated or otherwise readily ascertainable. A banking entity must identify any trading unit engaged in market making-related activities in such an asset class, and the trading unit must use whichever of three alternatives the banking entity believes most accurately reflects spreads in that asset class:

Guidance *(cont.)*	▪ End of Day Spread Proxy: Proxy based on spread used to estimate, or implied by, the market price at which the trading entity marks or would have marked the position for accounting purposes at the end of the day on which the purchase or sale is executed ▪ Historical Data Spread Proxy: Proxy based on historical spreads in similar market conditions ▪ Any other proxy that the banking entity can demonstrate accurately reflects spreads for the given asset class ▪ For any of the three methods above, the banking entity must be able to demonstrate that its choice most accurately reflects prevailing spreads for the given asset class ▪ End of Day Spread Proxy: Separately identify the portion of Spread Profit and Loss attributable to positions acquired and disposed of on the same day ▪ Historical Data Spread Proxy: Should be able to demonstrate that the proxy is appropriate, and should continually monitor market conditions and adjust the proxy as necessary
Calculation Period	One trading day.

B. Source-of-Revenue Measures
5. Comprehensive Profit and Loss Attribution

Description	Attribution analysis dividing the trading unit's Comprehensive Profit and Loss (slide B.1) into separate sources of risk and revenue that have caused any observed variation in Comprehensive Profit and Loss.
Guidance	▪ Should attribute Comprehensive Profit and Loss to specific market and risk factors that can be accurately and consistently measured over time ▪ Any component that cannot be specifically identified should be identified as unexplained ▪ Specific market and risk factors used should be tailored to a trading unit's trading activities ▪ Factors should be measured consistently over time ▪ Significant factors that have a consistent and regular influence on Comprehensive Profit and Loss (*e.g.*, certain Risk Factor Sensitivities (slide A.3)) should be identified ▪ Factors that influence Comprehensive Profit and Loss across different trading units should be measured and included in a comparable manner
Calculation Period	One trading day.

C. Revenue-Relative-to-Risk Measurements
1. Volatility of Comprehensive Profit and Loss and Volatility of Portfolio Profit and Loss

Description	Volatility of Comprehensive Profit and Loss: Standard deviation of the trading unit's Comprehensive Profit and Loss (slide B.1), estimated over a given calculation period. Volatility of Portfolio Profit and Loss: Standard deviation of the trading unit's Portfolio Profit and Loss (slide B.2), exclusive of Spread Profit and Loss (slide B.4), estimated over a given calculation period.
Calculation Period	30 days, 60 days and 90 days.

C. Revenue-Relative-to-Risk Measurements
2. Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio

Description	Comprehensive Profit and Loss to Volatility Ratio: Ratio of Comprehensive Profit and Loss (slide B.1) to the Volatility of Comprehensive Profit and Loss (slide C.1) for a trading unit over a given calculation period. Portfolio Profit and Loss to Volatility Ratio: Ratio of Portfolio Profit and Loss (slide B.2) (exclusive of Spread Profit and Loss (slide B.4)) to the Volatility of Portfolio Profit and Loss (slide C.1) (exclusive of Spread Profit and Loss (slide B.4)) for a trading unit over a given calculation period.
Calculation Period	30 days, 60 days and 90 days.

C. Revenue-Relative-to-Risk Measurements

3. Unprofitable Trading Days Based on Comprehensive Profit and Loss and Unprofitable Trading Days Based on Portfolio Profit and Loss

Description	Unprofitable Trading Days Based on Comprehensive Profit and Loss: Number or proportion of trading days over a given calculation period on which a trading unit's Comprehensive Profit and Loss (slide B.1) is less than 0. Unprofitable Trading Days Based on Portfolio Profit and Loss: Number or proportion of trading days over a given calculation period on which a trading unit's Portfolio Profit and Loss (slide B.2), exclusive of Spread Profit and Loss (slide B.4) is less than 0.
Calculation Period	30 days, 60 days and 90 days.

C. Revenue-Relative-to-Risk Measurements
4. Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss

Description	Should be calculated using standard statistical methods with respect to Portfolio Profit and Loss (slide B.2), exclusive of Spread Profit and Loss (slide B.4).
Calculation Period	30 days, 60 days and 90 days.

D. Customer-Facing Activity Measurements
1. Inventory Risk Turnover

Description	Ratio measuring the amount of risk associated with a trading unit's inventory, as measured by Risk Factor Sensitivities (slide A.3), that is turned over during a specific period of time. For each Risk Factor Sensitivity: ▪ Numerator: Absolute value of the Risk Factor Sensitivity associated with each transaction over the calculation period ▪ Denominator: Value of each Risk Factor Sensitivity for all the trading unit's holdings at the beginning of the calculation period
Guidance	▪ A trading unit should generally measure and report the ratio for each of the Risk Factor Sensitivities calculated and furnished for that unit
Calculation Period	30 days, 60 days and 90 days.

D. Customer-Facing Activity Measurements
2. Inventory Aging

Description	Describes the trading unit's aggregate assets and liabilities and the amount of time they have been held for the following periods: ▪ 0-30 days; 30-60 days; 60-90 days; 90-180 days; 180-360 days; greater than 360 days
Guidance	▪ Should be computed using a trading unit's trading activity data ▪ Should include both an asset aging schedule and a liability aging schedule, each of which records the value of assets or liabilities held for the periods listed above
Calculation Period	30 days, 60 days and 90 days.

D. Customer-Facing Activity Measurements
3. Customer-Facing Trade Ratio

Description	Ratio comparing: ▪ Number of transactions involving a counterparty that is a customer of the trading unit, to ▪ Number of transactions involving a counterparty that is not a customer of the trading unit

Guidance	▪ A counterparty is considered a customer of the trading unit for purposes of this metric if the counterparty is neither:
	  ▪ A counterparty to a transaction executed on a DCM registered under the Commodity Exchange Act or national securities exchange registered under the Securities Exchange Act;** nor
	  ▪ A broker-dealer, swap dealer, security-based swap dealer, any other entity engaged in market making–related activities, or affiliate thereof
	▪ A broker-dealer, swap dealer, security-based swap dealer, any other entity engaged in market making–related activities, or an affiliate thereof may be considered a customer for these purposes if the banking entity:
	  ▪ Treats that entity as a customer; and
	  ▪ Has documented how and why the entity is treated as a customer

Calculation Period	30 days, 60 days and 90 days.

** Note: Appendix B of the release, which contains regulators’ commentary on market making, states that when making a market in a security executed on an organized trading facility or exchange, a customer “is any person on behalf of whom a buy or sell order has been submitted by a broker-dealer or any other market participant.” It seems to be at odds with this prong of the Customer-Facing Trade Ratio calculation.

E. Payment of Fees, Commissions, and Spreads Measurement
1. Pay-to-Receive Spread Ratio

Description	Ratio comparing the amount of Spread Profit and Loss (slide B.4) and Fee Income (slide B.3) earned by a trading unit to such amount paid by the trading unit.
Guidance	▪ Should generally be computed using Spread Profit and Loss described in the proposal, except that: ▪ Spread paid should include the aggregate Spread Profit and Loss of all transactions producing negative Spread Profit and Loss ▪ Spread received should include the aggregate Spread Profit and Loss of all transactions producing a positive Spread Profit and Loss
Calculation Period	One trading day.

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Principles Distinguishing Market Making from Prohibited Proprietary Trading

Appendix B

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

A market maker must "hold itself out as being w**illing 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; and
- 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**; and
- 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.

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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**.

Features of Prohibited Proprietary Trading

Purpose	To generate profits as a result of, or otherwise benefit from, changes in the price of positions and risks taken.
Hedging	Proprietary traders seek to capitalize on price risks inherent in retained principal positions, and generally only hedge or manage a portion of such risks when doing so would improve the potential profitability of the risk.
Customers	Proprietary traders do not have customers because they only seek to obtain the best price and execution in purchasing and selling their principal positions.
Fees, Commissions and Spreads Earned or Paid	Proprietary traders generate few, if any, fees, commissions or spreads from trading activities and instead are likely to pay other market makers when utilizing their liquidity services.
Compensation	Proprietary traders generally provide personnel compensation incentives that primarily reward successful proprietary risk taking.

Distinguishing Permitted Market Making from Prohibited Proprietary Trading *(cont.)*

Features of Market Making

General	Where the banking entity acts as principal, market making-related activities generally involve: ▪ **In an organized trading facility or exchange**: passively providing liquidity by submitting resting orders that interact with the orders of others on a facility or exchange and acting as a registered market maker if registration is available (registration alone is not a sufficient basis for permitted activity) ▪ **In an OTC market**: providing an intermediation service to customers by assuming the role of a counterparty that stands ready to buy or sell a position that the customer wishes to buy/sell
Customers	Vary by asset class and market: ▪ **In an organized trading facility or exchange**: any person on behalf of whom a buy or sell order has been submitted by a broker-dealer or any other market participant ▪ **In an OTC market**: generally a market participant that makes use of the market maker's intermediation services either by requesting such services or entering into a continuing relationship with the market maker with respect to such services (in some cases, such as OTC derivatives markets, a "customer" may call itself a "counterparty")
Purpose	Primary purpose is to intermediate between buyers and sellers of similar positions; market makers are compensated for this service, resulting in more liquid markets and less volatile prices.

Distinguishing Permitted Market Making from Prohibited Proprietary Trading *(cont.)*

Features of Market Making

Purpose *(cont.)*	Purpose is not to earn profits as a result of movement in the price of positions and risks acquired or retained. Rather, a market maker generally manages and limits the extent to which it is exposed to movements in the price of such positions and risks or the price of one or more material elements.

Hedging	To the extent it can, a market maker will eliminate some or all of the price risks to which it is exposed. In some cases, the risks posed by one or more risks may be so complex or specific that the risk cannot be fully hedged.
	
	In other cases, it may be possible to hedge risks but the cost may be so high that obtaining full hedges would make such market making uneconomic.
	
	▪ In such cases, market makers must retain at least some risk for at least some period of time with respect to price movements of retained principal positions and risks
	▪ Size and type of risk that is retained may vary widely depending on:
	  ▪ Type and size of the positions
	  ▪ Liquidity of the specific market
	  ▪ Market structure
	▪ As the liquidity of positions increases, the frequency with which a market maker must take or retain risk in order to make a market generally decreases

Features of Market Making

Revenues and Profitability	Profitability relies on forms of revenues that reflect the value of intermediation services provided to customers
	▪ Typically take the form of explicit fees and commissions
	▪ In markets where no fees or commissions are charged, typically take the form of a bid-ask or similar spread
	▪ For derivative contracts, revenues reflect the difference between the cost of entering into the contract and the cost of hedging incremental, residual risks arising from the contract
	Typically, a market maker holds at least some risk with respect to price movements of retained positions and risks. As a result, the market maker also incurs profits or losses as price movements occur. However, these are incidental to customer revenues and significantly limited by the banking entity's hedging activities; customer revenues predominate over price movements.
	▪ The appropriate proportion of revenues from price movements to customer revenues varies according to:
	    ▪ Type of positions involved
	    ▪ Typical fees, commissions and spreads payable for transactions in such positions
	    ▪ Risks of such positions
	▪ Generally, the proportion of customer revenues generated when making a market in certain positions increases as:

Features of Market Making

Revenues and Profitability *(cont.)*	▪ Fees, commissions and spreads payable for those positions increase ▪ The volatility of those positions' prices decreases ▪ Prices for those positions are less transparent 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 consistent profitability and low earnings volatility under normal market conditions; the appropriate extent of such consistent profitability and low volatility varies according to: ▪ Type of positions involved ▪ Liquidity of the positions ▪ Price transparency of the positions ▪ Volatility of the positions' prices Generally, consistent profitability decreases and earnings volatility increases as: ▪ The liquidity of the positions decreases ▪ The volatility of the positions' prices increases ▪ The positions' prices are less transparent
Non-Customer Transactions	A market maker focuses activities on servicing customer demands and typically only transacts with non-customers to the extent that such transactions directly facilitate or support customer transactions.

Distinguishing Permitted Market Making from Prohibited Proprietary Trading *(cont.)*

Features of Market Making

Non-Customer Transactions *(cont.)*	Generally only transacts with non-customers to the extent necessary: ▪ To hedge or otherwise manage risks of market making–related activities, including managing risks with respect to price movements in retained principal positions and risks ▪ To acquire positions in amounts consistent with reasonably expected near-term demands of customers ▪ To sell positions acquired from customers Appropriate proportion of customer transactions to non-customer transactions varies depending on: ▪ The type of positions involved ▪ The extent to which the positions are typically hedged in non-customer transactions (*e.g.*, for a derivatives market maker engaging in dynamic hedging, the number of non-customer transactions significantly outweighs the number of customer transactions because market prices move and additional customer transactions change the risk profile of retained principal positions)
Fees, Commissions and Spreads Earned or Paid	A market maker typically engages in transactions that earn fees, commissions or spreads as payments for services.

Features of Market Making

Fees, Commissions and Spreads Earned or Paid *(cont.)*	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), such transactions may be necessary to prudently manage risk with respect to price movements in retained principal positions and risks Appropriate proportion of transactions that earn rather than pay fees, commissions or spreads varies based on: ▪ The type of positions involved ▪ The liquidity of the positions ▪ The extent to which market trends increase the volatility of risk with respect to price movements of retained principal positions and risks Generally, the proportion of transactions that earn rather than pay fees, commissions or spreads decreases as: ▪ The liquidity of the positions decreases ▪ The price volatility of retained principal positions and risks increases
Compensation	A market maker does not provide personnel compensation incentives that primarily reward proprietary risk taking

Proprietary Trading Quantitative Reporting Requirements Overview: Full List of Metrics by Category

Features of Market Making

Compensation *(cont.)*	May take into account revenues from movements in the price of retained principal positions and risks, reflecting the effectiveness with which personnel have managed the risk of such movements ▪ However, a market maker providing such compensation incentives generally does so through incentives that primarily reward customer revenues and effective customer service

Appendix B contains additional commentary distinguishing market making-related permitted activities from prohibited proprietary trading with respect to each of the following areas:

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

In each area, the commentary consists of:

- General remarks about prohibited proprietary trading absent explanatory facts and circumstances
- A description of how regulators will determine whether their analysis is indicative of market making-related permitted activities or prohibited proprietary trading
- Metrics regulators will use in their analysis
- Potential explanatory facts and circumstances

In order for trading activity to qualify as market making-related permitted activity, among other requirements, the market making-related activities of the trading desk or other unit must be consistent with this commentary.

The following slides provide a summary.

Commentary on Market Making
1. Risk Management

General	**Absent explanatory facts and circumstances**, trading activity in which a trading unit retains risk exceeding the size and type required to provide intermediation services to customers is prohibited proprietary trading rather than permitted market making-related activity.
How Regulators Will Make Their Determination	**Based on all available facts and circumstances**, including a comparison of retained principal risk to the following: ▪ The amount of risk generally required to execute a particular market making function ▪ Hedging options available in the market and permissible under the banking entity's hedging policy at the time of the activity in question ▪ The trading unit's prior levels of retained risk, and hedging practices with respect to similar positions ▪ The levels of retained risk and hedging practices of other trading units with respect to similar positions

Commentary on Market Making
1. Risk Management *(cont.)*

Metrics Regulators Will Use	▪ Var, Stress VaR, VaR Exceedance, Risk Factor Sensitivities, as applicable, among other risk measurements required to be reported, and any other relevant factor
	▪ Assessment will focus primarily on risk measurements relative to:
	  ▪ Risk required for conducting market making-related activities
	  ▪ Any significant changes in the risk over time and across similarly-situated trading units and banking entities

Potential Explanatory Facts and Circumstances	▪ Market-wide changes in risk ▪ Changes in the specific composition of market making-related activities ▪ Temporary market disruptions ▪ Other market changes that result in previously-used hedging or other risk management techniques no longer being possible or cost-effective

Commentary on Market Making
2. Source of Revenues

General	**Absent explanatory facts and circumstances**, trading activity in which a trading unit primarily generates revenues from price movements of retained principal positions and risks, rather than customer revenues, is prohibited proprietary trading rather than permitted market making-related activity.

How Regulators Will Make Their Determination	**Based on all available facts and circumstances**, including:
	▪ Revenues derived from price movements of retained principal positions and risks relative to customer revenues
	▪ A comparison of these revenue figures to:
	  ▪ The trading unit's prior revenues with respect to similar positions
	  ▪ The revenues of other banking entities' trading units with respect to similar positions

Metrics Regulators Will Use	▪ Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income and Expense, Spread Profit and Loss, as applicable, and any other relevant factor ▪ Metrics will be used both individually and in combination with each other (*e.g.*, by comparing the ratio of Spread Profit and Loss to Portfolio Profit and Loss)

Commentary on Market Making
2. Source of Revenues *(cont.)*

Potential Explanatory Facts and Circumstances	▪ General upward or downward price trends in the broader markets in which the trading unit is making a market—provided that revenues from price movements in retained principal positions/risks are consistent ▪ Sudden market disruptions or other changes causing significant, unanticipated alterations in the price of retained principal positions and risks ▪ Sudden and/or temporary changes in the market (*e.g.*, narrowing of bid-ask spreads) that cause significant, unanticipated reductions in customer revenues ▪ Efforts to expand or contract a trading unit’s market share

Commentary on Market Making
3. Revenues Relative to Risk

General	**Absent explanatory facts and circumstances**, trading activity is prohibited proprietary trading rather than permitted market making-related activity if the trading unit: ▪ Generates only very small or very large amounts of revenue per unit of risk taken ▪ Does not demonstrate consistent profitability; or ▪ Demonstrates high earnings volatility

How Regulators Will Make Their Determination	**Based on all available facts and circumstances**, including:
	▪ The amount of revenue per unit of risk taken, earnings volatility, profitability, exposure to risks and overall level of risk taking for the trading activity
	▪ A comparison of these figures to:
	    ▪ The trading unit’s prior results with respect to similar positions
	    ▪ The results of other banking entities’ trading units with respect to similar positions

Commentary on Market Making

3. Revenues Relative to Risk *(cont.)*

Metrics Regulators Will Use	▪ Riskiness of revenues; Amount of revenue per unit of risk: Volatility of Comprehensive Profit and Loss, Volatility of Portfolio Profit and Loss, Comprehensive Profit and Loss to Volatility Ratio, Portfolio Profit and Loss to Volatility Ratio, Comprehensive Profit and Loss Attribution, as applicable and any other relevant factor ▪ Consistent profitability: Unprofitable Trading Days Based on Comprehensive Profit and Loss, Unprofitable Trading Days Based on Portfolio Profit and Loss, as applicable, and any other relevant factor ▪ Exposure to outsize risk: Skewness of Portfolio Profit and Loss, Kurtosis of Profit and Loss, as applicable, and any other relevant factor
Potential Explanatory Facts and Circumstances	▪ Market disruptions or other changes causing significant unanticipated increases in a trading unit's risk with respect to movements in the price of retained principal positions and risks ▪ Market disruptions or other changes causing significant, unanticipated increases in the volatility of positions in which the unit makes a market ▪ Sudden and/or temporary changes in the market (*e.g.*, narrowing of bid-ask spreads) that cause significant, unanticipated changes in customer revenues and decreases in overall profitability ▪ Efforts to expand or contract the unit's market share

Proprietary Trading Quantitative Reporting Requirements
Overview: Full List of Metrics by Category

General	**Absent explanatory facts and circumstances**, trading activity is prohibited proprietary trading rather than permitted market making-related activity if the trading unit: ▪ 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, or ▪ Retains principal positions/risks in excess of reasonably expected near-term customer demand

How Regulators Will Make Their Determination	**Based on all available facts and circumstances**, including among other things:
	▪ The extent to which a trading unit's transactions are with customers as opposed to non-customers, and the frequency with which the unit's retained principal positions and risks turn over
	▪ A comparison of these figures to:
	    ▪ The unit's prior results with respect to similar positions and market situations
	    ▪ The results of other banking entities' trading units with respect to similar positions

Metrics Regulators Will Use	▪ Customers versus non-customers: Customer-Facing Trade Ratio, as applicable, and any other relevant factor ▪ Turnover of positions and risks: Inventory Risk Turnover and Inventory Aging, as applicable, and any other relevant factor

4. Customer-Facing Activity *(cont.)*

Potential Explanatory Facts and Circumstances	With respect to trading activity in which a trading unit either 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: ▪ Sudden market disruptions or other changes causing significant increases in the unit's hedging transactions with non-customers; or ▪ Substantial intermediary trading required to satisfy customer demand and hedging management With respect to trading activity in which a trading unit retains principal positions and risks in excess of reasonably expected near-term customer demands: ▪ Sudden market disruptions or other changes causing a significant reduction in actual customer demand relative to expected customer demand ▪ Documented and reasonable expectations for temporary increases in customer demand in the near term; and ▪ Sudden market disruptions or other changes causing a significant reduction in the value of retained principal positions/risks, such that it would be imprudent for the unit to dispose of the positions in the near term

Commentary on Market Making
5. Payment of Fees, Commissions, and Spreads

General	**Absent explanatory facts and circumstances**, trading activity in which a trading unit routinely pays rather than earns fees, commissions or spreads is prohibited proprietary trading rather than permitted market making-related activity.

How Regulators Will Make Their Determination	**Based on all available facts and circumstances**, including among other things:
	▪ The frequency with which the unit pays fees, commissions or spreads and the relative amount paid as opposed to earned
	▪ A comparison of these figures to
	  ▪ The unit's prior results with respect to similar positions
	  ▪ The results of other banking entities' trading units with respect to similar positions

Metrics Regulators Will Use	▪ Pay-to-Receive Spread Ratio, as applicable, and any other factor

5. Payment of Fees, Commissions, and Spreads *(cont.)*

Potential Explanatory Facts and Circumstances	▪ Sudden market disruptions or other changes causing: ▪ Significant increases in a trading unit's hedging transactions with non-customers, for which it must pay fees, commissions or spreads ▪ Sudden, unanticipated customer demand for liquidity requiring the unit itself to pay fees, commissions or spreads to other market makers for liquidity services in order to obtain inventory needed to meet customer demand ▪ Significant, unanticipated reductions in fees, commissions or spreads earned by the unit ▪ A trading unit's efforts to expand or contract market share

Commentary on Market Making
6. Compensation Incentives

General	**Absent explanatory facts and circumstances**, trading activity of a trading unit that provides employee compensation incentives that primarily reward proprietary risk taking will be considered prohibited proprietary trading rather than permitted market making-related activity.
How Regulators Will Make Their Determination	**Based on all available facts and circumstances**, including among other things: ▪ The extent to which compensation incentives provided to trading unit personnel reward revenues from movements in the price of retained principal positions and risks ▪ The extent to which compensation incentives provided to trading unit personnel reward customer revenues ▪ The compensation incentives provided by other banking entities to similarly-situated personnel

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.

Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Key Definition of Trading Unit

Trading Unit	Each of the following units of organization of a banking entity:
	▪ Each discrete unit that is engaged in the coordinated implementation of a revenue-generation strategy and that participates in the execution of any covered trading activity
	  ▪ Regulators expect that this will include each unit generally understood to be a "trading desk," and that this will generally be the smallest unit of organization used by the entity to structure and control its risk-taking activities and employees
	▪ Each organizational unit that is used to structure and control the aggregate risk-taking activities and employees of one or more trading units described in the bullet point above
	  ▪ Regulators expect that this will generally include management or reporting divisions, groups, sub-groups, or other intermediate units of organization used to manage one or more discrete trading units (*e.g.*, "North American Credit Trading," "Global Credit Trading," etc.)
	▪ All trading operations collectively
	▪ Any other unit of organization specified by regulators with respect to a particular banking entity

Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Internal Policies and Procedures

General—Enhanced Program Requirements	A banking entity with at least $1 billion in trading assets and liabilities is subject to enhanced program requirements and must establish, maintain and enforce written policies and procedures reasonably designed to document, describe and monitor covered trading activities and the risks taken in these activities.
Identification of Trading Account	Policies and procedures must specify how the banking entity evaluates its covered financial positions and how it determines which of its accounts are "trading accounts" as defined in the rules.
Identification of Trading Units and Organization Structure	Written policies and procedures must identify and document each trading unit and map each trading unit to the division, business line or other organizational structure used to manage or oversee the trading unit's activities.
Description of Missions and Strategies	Written policies and procedures for each trading unit must clearly articulate and document a comprehensive description of the unit's mission (*i.e.*, the nature of business conducted) and the unit's strategy (*i.e.*, the business model for generating revenue). They must include a description of: ▪ How revenues are intended to be generated by the trading unit

Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Internal Policies and Procedures *(cont.)*

Description of Missions and Strategies *(cont.)*	▪ Activities the trading unit is authorized to conduct, including:
	  ▪ Authorized instruments and products
	  ▪ Authorized hedging strategies and instruments
	▪ Expected holding period of, and market risk associated with, covered positions held in the unit's trading account
	▪ Types of clients, customers and counterparties with whom the unit conducts trading
	▪ If the trading unit engages in market making–related permitted activity, how it identifies customers for purposes of the Customer-Facing Trade Ratio if applicable, including documentation explaining when, how and why a broker-dealer, swap dealer, SBS dealer, any other entity engaged in market making-related activities or any affiliate is considered to be a customer for such purposes
	▪ The compensation structure of employees associated with the unit

Trader Mandates	Must establish, maintain and enforce trader mandates for each unit which, at a minimum: ▪ Clearly inform each trader of Volcker Rule implementing rule requirements, and the trader's compliance responsibilities ▪ Set forth appropriate parameters for each trader involved in activities within the scope of the Volcker Rule, including: ▪ Conditions for relying on permitted activities

Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Internal Policies and Procedures *(cont.)*

Trader Mandates *(cont.)*	▪ Pursuant to internal controls, which financial contracts, products and underlying assets the trader is allowed to trade ▪ The risk limits of the trading unit, and the types and levels of risk that may be taken ▪ The applicable trading unit hedging policy

Description of Risks and Risk Management Policies	Each trading unit's written policies and procedures must clearly articulate and document a comprehensive description of the risks associated with the trading unit, including at a minimum:
	▪ A description of the supervisory and risk management structure governing the trading unit, including a description of initial and senior-level review processes for new products and strategies
	▪ A description of the types of risks that may be taken to implement the unit's mission and strategy, including:
	  ▪ All significant price risks (*e.g.*, basis, volatility, correlation)
	  ▪ Any significant counterparty credit risk associated with the trading activity
	▪ An articulation of the amount of risk allocated by the banking entity to the unit to implement the unit's documented mission and strategy
	▪ An explanation of how the risks allocated to the unit will be measured
	▪ An explanation of why the allocated risk levels are appropriate to the unit's mission and strategy.

Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Internal Policies and Procedures *(cont.)*

Hedging Policies and Procedures	Must establish, maintain and enforce policies and procedures for all trading units regarding the use of risk-mitigating hedging instruments and strategies, including at a minimum: ▪ The manner in which the banking entity will determine that the risks generated by each unit have been properly and effectively hedged ▪ The instruments, techniques and strategies to be used to hedge the risk of positions or portfolios ▪ The level of organization at which hedging activity and management will occur ▪ The manner in which hedging strategies will be monitored ▪ The risk management processes used to control unhedged or residual risks ▪ The independent testing of hedging techniques and strategies
Explanation of Compliance	Written policies and procedures must clearly articulate and document a comprehensive explanation of how each trading unit's mission and strategy and its related risk levels comply with implementing rules. Such explanations must: ▪ Identify which portions of the unit's risk-taking activity would or would not constitute covered trading activity within the scope of the Volcker Rule ▪ Identify activities that the unit will conduct in reliance on permitted activity exemptions, including an explanation of:

Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Internal Policies and Procedures *(cont.)*

Explanation of Compliance *(cont.)*	▪ How and where the activity occurs ▪ Which exemption is being relied upon, and how the activity meets the applicable requirements for the exemption ▪ Describe how the banking entity monitors for and prohibits potential or actual material exposure to high-risk assets or high-risk trading strategies presented by each trading unit, which must take into account potential or actual exposure to: ▪ Assets whose values cannot be externally priced, or if valuation relies on pricing models, whose model inputs cannot be externally validated ▪ Assets whose changes in value cannot adequately be mitigated by effective hedging ▪ New products with rapid growth including those without a market history ▪ Assets or strategies with significant embedded leverage ▪ Assets or strategies with significant historical volatility ▪ Assets or strategies for which the application of capital and liquidity standards would not adequately account for risk

Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Internal Policies and Procedures *(cont.)*

Explanation of Compliance *(cont.)*	▪ Assets or strategies that result in large and significant concentrations to sectors, risk factors or counterparties ▪ Explain how each trading unit will comply with Volcker Rule reporting and recordkeeping obligations ▪ Explain how the banking entity monitors for and prohibits potential or actual material conflicts of interests with clients, customers or counterparties ▪ Explain how the banking entity monitors for and prohibits potential or actual transactions or activities that may threaten its safety and soundness
Remediation of Violations	Written policies and procedures must require the banking entity to promptly document, address and remedy any violation of the Volcker Rule statute or implementing rules, and document all proposed or actual remediation efforts. Must include specific procedures reasonably designed to implement and monitor any required remediation, and assess the extent to which any violation indicates that modification of the compliance program is warranted. With respect to any trading unit that is either used to structure and control the aggregate risk-taking activities of one or more trading units, or comprised of the banking entity's entire trading operation: ▪ The description of missions and strategies, risks and risk management processes and explanation of trading unit compliance may incorporate by reference the policies and procedures of the underlying trading units

Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Internal Controls

General	Must establish, maintain and enforce written internal controls: ▪ Reasonably designed to ensure that the trading activity of each trading unit is appropriate and consistent with written description of mission, strategy and risk mitigation ▪ Reasonably designed and established to effectively monitor, and identify for further analysis, any covered trading activity that may indicate potential violations of the Volcker Rule and implementing rules, and to prevent actual violations ▪ Must describe procedures for remedying violations
Authorized Risks, Instruments and Products	Must implement and enforce internal controls for each trading unit, reasonably designed to ensure that trading activity is conducted in conformance with documented authorized risks, instruments and products. At a minimum, controls must monitor and govern, in each case consistent with policies and procedures: ▪ Types and levels of risks that may be taken by each trading unit ▪ Type of hedging instruments and strategies used, and the amount of risk effectively hedged ▪ Financial contracts, products and underlying assets the trading unit may trade

Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Internal Controls *(cont.)*

Risk Limits	Must establish and enforce risk limits appropriate for each trading unit, including the following measured under normal and stress market conditions: ▪ Limits based on probabilistic measures of potential loss (*e.g.*, VaR) ▪ Limits based on non-probabilistic measures of potential loss (*e.g.*, notional exposure)
Analysis and Quantitative Measurements	Must perform robust analysis and quantitative measurement of covered trading activities, reasonably designed to: ▪ Ensure that the trading activity of each unit is consistent with its documented mission, strategy and risk management process ▪ Monitor and assist in identification of potential/actual prohibited proprietary trading activity ▪ Prevent the occurrence of prohibited proprietary trading In addition to Appendix A quantitative metrics, each banking entity must develop and implement, to the extent necessary to facilitate compliance, additional metrics specifically tailored to its trading units Must incorporate the Appendix A metrics reported to regulators and include, at a minimum: ▪ Internal controls and written policies/procedures reasonably designed to ensure the accuracy/integrity of quantitative measurement ▪ Ongoing, timely monitoring and review of metrics calculated

Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Internal Controls *(cont.)*

Analysis and Quantitative Measurements *(cont.)*	▪ Heightened review of a quantitative measurement when the measurement raises any questions regarding compliance with the Volcker Rule implementing rules, **including** numerical thresholds for each trading unit for triggering heightened review
	  ▪ Must include in-depth analysis, appropriate escalation procedures and documentation related to the review
	▪ When a quantitative measurement, considered with facts and circumstances, suggests a reasonable likelihood that the trading unit has violated any part of the Volcker Rule implementing rules:
	  ▪ Immediate review and compliance investigation of the trading unit's activities
	  ▪ Escalation to senior management with oversight responsibility for the trading unit
	  ▪ Timely notification to the relevant regulator
	  ▪ Appropriate remedial action (*e.g.*, divestment of impermissible positions, cessation of impermissible activity, disciplinary actions)
	  ▪ Documentation of investigation findings and remedial action taken

Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Internal Controls *(cont.)*

Surveillance of Program Effectiveness	The banking entity must regularly monitor the effectiveness of its program and take prompt action to address and remedy any deficiencies identified. ▪ Any remedial action taken must be documented and maintained as a record by the banking entity

Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Responsibility and Accountability

General	Must have an appropriate management framework reasonably designed to ensure that: ▪ Appropriate personnel are responsible and accountable for effective implementation and enforcement ▪ A clear reporting line and chain of responsibility are delineated ▪ The board of directors (or similar body) and CEO reviews and approves the program
Corporate Governance	The banking entity must ensure that its compliance program is reduced to writing, approved by the board of directors or similar corporate body, and noted in the minutes.
Trader Mandates	Must establish, maintain and enforce trader mandates to clearly inform each trader within a trading unit of his/her Volcker Rule responsibilities.
Management Procedures and Written Procedures	Must establish, maintain and enforce procedures reasonably designed to achieve compliance with the Volcker Rule implementing rules.

Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Responsibility and Accountability *(cont.)*

Management Procedures and Written Procedures *(cont.)*	At a minimum, must provide for:
	▪ Designation of at least one person with authority to carry out the banking entity's responsibilities for each trading unit
	▪ Written procedures reasonably designed to achieve compliance with the Volcker Rule implementing rules, including:
	  ▪ Procedures for manager review of the trading unit's activities and quantitative measurements (including those required by the proposal and any other such measurements tailored to the trading units)
	  ▪ A description of the management system, including titles, qualifications and locations of managers, and the specific responsibilities of each person with respect to trading units
	  ▪ Procedures for determining compensation arrangements for traders engaged in underwriting or market making–related activities so that the arrangements are not designed to reward proprietary risk taking

Business Line Managers	Managers with responsibility for one or more trading units engaged in covered activities or investments are accountable for the effective implementation and enforcement with respect to the trading unit.

Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Responsibility and Accountability *(cont.)*

Senior Management	Senior management must ensure that effective corrective action is taken when violations of the Volcker Rule implementing rules are identified. ▪ May include divestiture of the position, cessation of the activity or disciplinary measures Senior management and Volcker Rule control personnel should report to the Board of Directors (or an appropriate Board committee) on the effectiveness of compliance at least once every 12 months, and with a frequency appropriate to the size, scope and risk profile of covered activities.
Board of Directors (or Similar Body) and CEO	These entities are responsible for setting an appropriate culture of compliance with the implementing rules and establishing clear policies regarding the management of covered activities or investments in compliance with the Volcker Rule implementing rules. Board or similar body must ensure that senior management is fully capable, qualified and properly motivated to manage compliance, in light of the organization's business activities. ▪ Must also ensure that senior management has established appropriate incentives to support compliance, including the implementation of the compliance program into management goals and compensation structures across the banking entity

Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Independent Testing

What Independent Testing Must Evaluate	Overall adequacy and effectiveness, including analysis of the extent to which the program meets all requirements specified in the interagency proposal. Effectiveness of written policies and procedures. Effectiveness of internal controls. ▪ Must include analysis and documentation of instances in which internal controls were breached, including how the breaches were addressed and resolved Effectiveness of management procedures.
Who May Conduct Independent Testing	A "qualified independent party" such as an internal audit department, outside auditors, consultants or others.
Frequency of Independent Testing	Frequency should be appropriate to the size, scope and risk profile of covered trading activities, and at least once every 12 months.
Action to Be Taken in Response	The banking entity must take appropriate action to remedy any concerns identified, including remedying deficiencies in controls and policies themselves.

Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Training

Goal of Training	To effectively implement and enforce the compliance program. The release does not otherwise specify the content of required training.
Who Must Receive Training	Trading personnel, managers and other appropriate personnel as determined by the banking entity.
Who May Conduct Training	Either internal or independent parties, as deemed appropriate by the banking entity based on size and risk profile.
Frequency of Training	Not specified, but frequency should be appropriate to the size and the risk profile of covered trading activities.

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Enhanced Compliance for Banking Entities with $1 Billion or More in Trading Assets and Liabilities: Recordkeeping

Content	Must create and retain records sufficient to demonstrate compliance and support the operations and effectiveness of the compliance program.
Time Period	At least 5 years.
Format	Must be able to promptly produce records to regulators on request.

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Volcker Rule Proposed Regulations: Links to Flowcharts

Proprietary Trading

- Summary
- With Annex

Hedge / PE Funds

- Summary
- With Annex