DISCUSSION OUTLINE FOR THE PROPOSED VOLCKER RULE
PROPRIETARY TRADING AND DERIVATIVES
October 2011

1. **Scope of Rule:**

A. Statute (Section 619 of Dodd-Frank Act) calls for a prohibition on the trading of certain securities and instruments through a trading account.

B. Proposed rule maintains this structure, but the regulators have exercised their discretion under the statute to define broadly the two key elements of this prohibition:

(i) Covered Financial Positions: new defined term in Proposed Rule that identifies relevant securities and instruments

(ii) Trading Account: Proposed Rule significantly expands this concept

2. **Covered Financial Positions:**

A. Several elements of Statute have been broadly defined in the rule proposal:

(i) Derivatives (a type of Covered Financial Position) are defined to include, in additional to all Title VII swaps:

(1) forward contracts on nonfinancial commodities

(2) FX swaps and FX forwards

(3) retail FX transactions

(4) retail commodity transactions

(ii) By explicitly covering nonfinancial commodity forwards and all FX transactions, the regulators have used their discretion to define Covered Financial Position more broadly than the base line definition suggested by the Statute.

B. Proposed rule expressly excludes from Covered Financial Position:

(i) Consumer and commercial agreements that the CFTC/SEC exclude from their swap definition via rulemaking and interpretation

(ii) Identified banking products

(iii) Certain repurchase or reverse repurchase agreements

(iv) Certain securities lending agreements

(v) Positions used in liquidity management programs that comply with regulatory criteria

(vi) Outright holdings of commodities or foreign currencies or loan positions

3. **Trading Account:**

A. Statutory definition focused on positions held "principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)", and allowed regulators to add other elements.

B. In the Proposed Rule, the regulators have arguably expanded the base statutory definition in two ways:

(i) First, by giving a broad interpretation to the "near term/short-term" concept, and

(ii) Second, by using their discretion to add other major elements to the definition of trading account

C. There are several ways in which the "near-term/short-term" concept has been interpreted to expand the scope of trading account:

(i) Explicitly covered "realizing short-term arbitrage profits" in trading account definition (though no mention of arbitrage in Statute)

(ii) Also covers hedging positions that relate to any of the other types of short term transactions referenced in the definition

(iii) Used somewhat broader wording in Proposed Rule by referring to transactions that are for the purpose of "benefitting from actual or expected short-term price movements"

(iv) In the Preamble to Proposed Rule, the regulators commented on this wording, noting that:

(1) no actual resale is required to be considered "near term/short-term"

(2) definition could be triggered by entering into one transaction in the near-term to offset or close out another, perhaps longer-term, position

(3) other examples of combined transactions are given as potentially falling within the ambit of trading account (even a long-term derivative or future that provides for short-term variation margin where the banking entity intends to benefit from short-term price movements could be considered "near term/short-term")

(v) Finally, the Proposed Rule adds a rebuttable presumption that covered financial positions evaluated under the short-term component will be deemed in a trading account if held for 60 days or less, unless otherwise demonstrated, based on facts and circumstances, that positions were not held for one of the enumerated short term purposes

(1) the broad wording used by the Proposed Rule to identify short term activity places a significant burden on banking entities trying to rebut the 60 day presumption

D. In addition to covering "short-term positions", the regulators expanded the trading account definition in two significant ways:

(i) First, by explicitly including certain covered financial positions that are "covered positions" under the market risk capital rules that apply to various banking entities:

(1) market risk capital rules have historically used the concept of trading account to identify covered positions, including short term positions, for various risk capital purposes

(2) regulators decided to draw on this in constructing the Volcker Rule trading account definition

(3) in the Preamble, the regulators acknowledge these similarities and state that they wanted to achieve some consistency with the approach already reflected in the market risk capital rules

(4) however, they exclude from this group all FX derivatives, commodity derivatives and commodity futures because the market risk capital rules do not separate long and short term positions for these instruments.

(5) in the related Preamble discussion, the regulators cite FASB guidance stating that "near-term" for purposes of classifying trading activities is "generally measured in hours and days rather than months or years." This accounting guidance seemed to have little impact on how the regulators have shaped the Volcker Rule trading account definition.

(ii) Second, by explicitly including positions taken by securities dealers, swap dealers and security-based swap dealers

(1) the Proposed Rule includes covered financial positions taken for any purpose if the position is in connection with the activities that caused such entity to register as a dealer

(2) this reflects regulators view that all assets of a dealer are held either:

- as part of its dealing activity generally for sale to customers upon request or
- to support trading activities that should be caught by trading account definition

(3) in other words, to the extent a dealer isn't dealing (i.e., making markets) its activities are likely to fall within the Volcker Rule prohibition

4. Permissible Market Making:

A. Because of the broad interpretation of trading account, particularly the manner in which dealer activities are covered, the scope of the exemption for permissible market making is critical

B. To engage in permissible market making, the Proposed Rule requires that a covered entity must

(i) Establish an internal compliance program meeting various substantial requirements,

(ii) Hold itself (or its relevant trading unit) out as willing to buy and sell covered financial positions for its own account on a regular or continuous two way basis,

(iii) Only engage in activities relating to covered financial positions that are designed not to exceed the reasonably expected near term demand of clients, customer or counterparties, and

(iv) Be an appropriate U.S. registered entity (BD, swap dealer, SBSD or muni or govt securities dealer) or comparable foreign entity subject to substantive home jurisdiction regulation

C. Revenues must be primarily from fees, commissions, bid/ask spreads and not attributable to:

(i) Appreciation of covered financial positions in trading account or

(ii) Hedging of such covered financial positions

D. Compensation must be designed to not reward risk-taking

E. Market making can include a covered financial position executed to hedge if that position reduces "specific risks" related to individual or aggregate positions otherwise permitted as market making

F. As to what constitutes "bona fide" market making, the Preamble provides further insights as to the Regulators' views:

(i) Making a market in one type of covered financial position does not make an entity a market maker for any other type of covered financial position

(ii) What an entity must do to meet the market making standard varies with the liquidity, size, infrastructure, trading volumes and frequency and location of each particular market, so that:

- in highly liquid market (e.g., equity securities) would expect to see continuous two sided quotes
- in less liquid market (e.g., OTC bond market) would need to provide quotes on a regular (but not necessarily continuous) basis
- for derivatives, reference is made to the swap dealer and SBSD standards being established by the CFTC and SEC in their rule making, which does not limit dealer status to entities that maintain continuous two sided quotes
- block positioning, as historically described in SEC regulations, is a permitted for of market making

G. Proposed Rule establishes a host of quantitative measures that will be used to identify and monitor permitted market-making (as well as other permitted) activities:

(i) Appendix A to the Proposed Rule outlines and defines a long list of quantitative tests and measures that are to be applied to various permitted activities

(ii) Appendix B to the Proposed Rule focuses on market making, by:

(1) providing detailed commentary regarding how the regulators will tend to distinguish permissible market making from activities that constitute prohibited proprietary trading, and

(2) describes how the various quantitative measures will be applied to assess the permissibility of market making activities.

(3) the quantitative measures are to be applied as follows:

- various VaR based measures to assess whether retained risks exceed levels appropriate for market making based intermediation activities
- various profit and loss measures to assess whether revenues are excessively derived from price movements rather than from customer revenues such as fees, commissions and spreads
- various volatility, profitability and probability based measures to assess whether there are excessive misalignments of revenue and risk, excessively inconsistent profitability or excessive earnings volatility for bona fide market making
- ratio of customer to non-customer facing revenues to identify excessive non customer revenue sources
- ratio of payments to revenues received to identify excessive trading activity relative to customer revenue based activity
- degree to which compensation incentives are tied to price movements rather than customer revenues to identify compensation arrangements that are not appropriate for market making

(4) conclusions based on these quantitative measures can always be overridden by explanatory facts and circumstances, examples of which are also provided

(iii) The premise of Appendix B is that the regulators will be able to audit market making activities by applying these various quantitative measures to assess whether an entity is engaging in impermissible activities

5. **Permissible Hedging:**

A. The Proposed Rule adheres closely to original statutory wording.

B. To engage in permissible hedging, the Proposed Rule provides that a covered entity may take a covered financial position if it:

(i) Is "designed" to reduce "specific risks" of the banking entity

(ii) Is related to individual or aggregate positions or holdings of the banking entity

C. To operate under this exemption, a banking entity:

(i) Must establish an internal compliance program meeting various substantial requirements

(ii) Hedge or mitigate specific risks, including:

- market risk
- credit risk
- currency risk
- interest rate risk
- basis risk

(iii) Have executed a position that is "reasonably correlated" to targeted risk, which can reflect:

- nature of the underlying and hedged positions
- the liquidity and risks of those positions

(iv) Should not create, at inception, new significant unhedged exposures, as to which the Preamble draws a distinction between:

- new counterparty credit risk or basis risk which inevitably arise and aren't likely to represent proprietary trading, versus

– correlation or paired trading strategies or even overhedging which they deem likely to be proprietary trading rather than exempt hedging activity

(v) May not have compensation arrangements designed to reward proprietary risk taking.

D. Continuing monitoring is also required to assure:

(i) Ongoing compliance with policies and procedures

(ii) Maintenance of reasonable level of correlation

(iii) Mitigation of any significant exposures that later arise from the hedge

E. Proposed Rule acknowledges the possibility that hedging may occur at a group level and be allocated to various business lines and requires documentation to support such arrangements.

F. In the Preamble, the regulators acknowledge that permitted hedging would encompass

(i) Adjustments as a result of dynamic or delta hedging

(ii) Anticipatory hedging but only under closely controlled circumstances

G. The Preamble also discusses what is meant by "reasonable correlation":

(i) Acknowledges that it doesn't mean "full correlation"

(ii) Degree of correlation will vary with nature of position being hedged and availability of other hedging options

(iii) However, if profit potential on hedge is appreciably greater than loss potential on related position, that would be considered a marker for a non-exempt proprietary position

Quantitative Measures Required under the Proposed Volcker Rule:

A. Covered entities with total average trading assets and liabilities of $5 billion or more will be required to calculate and report the following quantitative measures (separately for each trading unit involved in the relevant activity):

(i) for an entity engaged in Market Making (17 measures):

- Value-at-Risk 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;
- Comprehensive Profit and Loss Attribution;
- Pay-to-Receive Spread 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;
- 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; and
- Customer-facing Trade Ratio;

(ii) for an entity engaged in Underwriting, Hedging and other Permissible Trading (5 measures):

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

B. Covered entities with total average trading assets and liabilities greater than $1 billion but less than $5 billion that are engaged in Market Making will be required to calculate and report the following quantitative measures (8 measures):

- Comprehensive Profit and Loss;
- Portfolio Profit and Loss;
- Fee Income and Expense;
- Spread Profit and Loss;
- Value-at-Risk;
- Comprehensive Profit and Loss Attribution;
- Volatility of Comprehensive Profit and Loss and Volatility of Portfolio Profit and Loss; and
- Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio.