Volcker Rule: Hedging, Market Making and Regulatory Oversight

January 14, 2014
Presented By
Julian E. Hammar
On December 10, 2013, the five relevant U.S. regulatory agencies (Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation, Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) approved the final version of the Volcker Rule.

Very detailed release of almost 900 pages.

The rule, promulgated pursuant to section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), will substantially limit the circumstances in which many banking entities may enter into derivatives.

Because of prohibitions of trading activities of banking entities, the rule could substantially reduce market liquidity.
Overview

• The Volcker Rule applies to a very broad range of banking entities, including insured depository institutions, companies controlling an insured depository institution, foreign banking organizations with U.S. operations, and any affiliate or subsidiary of any of the foregoing.

• Two primary parts:
  1) Prohibition on proprietary trading and
  2) Prohibition on ownership interests in, or sponsorship of, certain investment companies and commodity pools, known as “covered funds.”

• This presentation will focus on:
  • proprietary trading,
  • permitted risk-mitigating hedging,
  • permitted market making, and
  • regulatory oversight under the Volcker Rule.
Proprietary Trading

• **Prohibition**: The Volcker Rule generally provides that a banking entity may not engage in proprietary trading – “engaging as principal for” its own “trading account” in a “purchase or sale of one or more financial instruments,” including derivatives.
  - Definition of “trading account” includes, among other things:
    - any account used by a banking entity to purchase or sell financial instruments for “short-term” resales, price movements or arbitrage profits and
    - any account of a banking entity that is a dealer, swap dealer or security-based swap dealer in connection with its dealing.
  - Definition of “financial instrument” includes most derivatives (e.g., futures, swaps and options) as well as nonfinancial forwards.
• **Rebuttable Presumption**: Rebuttable presumption that if a banking entity holds a financial instrument for less than 60 days, the purchase or sale of such instrument is for the banking entity’s trading account.
Proprietary Trading Exclusions

The following are excluded from proprietary trading:

• Repurchase or reverse repurchase agreements;
• Securities borrowed pursuant to a written securities lending agreement meeting certain conditions;
• Positions for liquidity management purposes;
• Certain positions held by derivatives clearing organizations or clearing agencies;
• Excluded clearing related activities by clearing house members;
• Satisfying an existing delivery obligation or an obligation in connection with a judicial, administrative, self regulatory organization or arbitration proceeding;
• Transactions when acting solely as an agent, broker or custodian;
• Deferred compensation plans; and
• Collecting a debt previously contracted.
Permitted Proprietary Trading

The prohibition on proprietary trading does not apply to:

- Certain risk-mitigating hedging activities.
- Certain market-making activities (as well as certain underwriting activities).
- Trading in certain instruments:
  - U.S. government or government agency securities;
  - municipal bonds; and
  - for U.S. affiliates of foreign banking entities or foreign affiliates of U.S. banking entities, certain foreign sovereign debt obligations.
- Trading in certain capacities:
  - On behalf of customers as fiduciary or riskless principal.
  - Banking entities that are regulated insurance companies acting for their general or separate insurance account.
- Trading by Foreign Banking Organizations solely outside the U.S.
Risk-Mitigating Hedging Activities

- **Specific Risks**: Exemption from proprietary trading prohibition extends to risk-mitigating hedging activities designed to reduce specific risks of the banking entity.

- **Portfolio Hedging**: Although “portfolio hedging” is not expressly allowed, a banking entity may engage in hedging activities that are “in connection with and related to individual or aggregated positions, contracts or other holdings” (emphasis added).

- **Hedges of General Risks Not Permitted**: Permitted hedging activity does not extend to hedging of general risks that are not related to specific positions, such as risks associated with assets or liabilities of the banking entity generally or risks associated with general market movements or broad economic conditions.
Conditions

Risk-mitigating hedging activities of banking entities in order to be permitted must be conducted under the following conditions:

• Establishment of a compliance program;
• Risk-mitigating hedging activity must meet certain requirements;
• Certain restrictions on compensation arrangements; and
• Enhanced documentation in certain circumstances.
Compliance Program

Requirements: The internal compliance program must be reasonably designed to ensure the banking entity’s compliance with the exception for risk-mitigating hedging, including:

- **Policies:** Written policies and procedures regarding the positions, techniques and strategies that may be used for hedging, including:
  - Documentation indicating what positions, contracts or other holdings a particular “trading desk”* may use and
  - Position and aging limits;
- **Controls:** Internal controls and ongoing monitoring, management and authorization procedures (including escalation procedures) and

*A trading desk is defined as the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof.
Compliance Program (cont’d.)

• **Analysis:** Analysis (including correlation analysis) and independent testing designed to ensure that the positions, techniques and strategies that may be used for hedging may reasonably be expected to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks being hedged.

• **Extent:** Extent of the required compliance program will depend upon the size and activities of the banking entity, but for entities engaging in proprietary trading with consolidated assets of $10 billion or more it will be quite substantial.

• **Enhanced Compliance:** Those entities with consolidated assets of $50 billion or more have “enhanced minimum standards for compliance programs” noted in Appendix B to the rule.
Requirements for Hedging

Risk-mitigating hedging activity must meet the following requirements to be exempt from the proprietary trading prohibition:

- **Policies:** Hedging activity must be conducted in accordance with written polices, procedures and internal controls adopted under the compliance program;
- **Reduce or Significantly Mitigate Risk:** Hedging activity must be designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks arising in connection with identified positions, contracts, or other holdings, at the inception of hedging activity and on an ongoing basis (including any adjustments);
Requirements for Hedging (cont’d.)

• **No New or Additional Risk**: Hedging activity must not give rise, at the inception of the hedge, to any significant new or additional risk that is not itself hedged contemporaneously; and

• **Ongoing Review and Recalibration**: Hedging activity is subject to continuing review, monitoring and management consistent with the required policies and ongoing recalibration of the hedging activity.
Anticipatory and Dynamic Hedging

- **Anticipatory hedging**: Anticipatory hedging (hedging before the banking entity becomes exposed to the underlying risk) is permitted so long as it meets the above requirements for hedging.
  - Unlike under the proposed rule, the anticipatory hedge does not have to be established “slightly” before the banking entity becomes exposed to the underlying risk.
  - But if the risk does not materialize, the hedge must be extinguished as soon as reasonably practicable.
- **Dynamic hedging**: Dynamic hedging (a series of hedging transactions designed to rebalance hedging positions based on changes resulting from permissible activities or from a change in the price or other characteristic of the positions(s) being hedged) likewise is permitted if it meets the above requirements for hedging.
Compensation

• **Requirement**: Compensation arrangements of persons performing risk-mitigating hedging activities are designed not to reward or incentivize prohibited proprietary trading.

• **Applicability to other permitted activities**: Similar requirement applies to permitted market-making and underwriting activities.
Enhanced Documentation

• For certain types of hedging activities, the banking entity must comply with enhanced documentation requirements.

• These hedging activities are the following:
  • **Cross-desk and Cross-Affiliate Hedging**: Hedging activities not established by the specific trading desk responsible for the underlying positions being hedged;
  • **Hedging strategies not identified in polices and procedures**: Hedging activities that are effected through a financial instrument, exposure, technique or strategy not specifically identified in applicable polices and procedures; and
  • **Aggregated Hedging**: Hedging activities established to hedge aggregated positions across two or more trading desks.
Documentation Requirements

• **Content**: A banking entity contemporaneously with the establishment of the specified hedges must document:
  • The specific, identifiable risk(s) designed to be reduced;
  • The specific risk-mitigating strategy the purchase or sale is designed to fulfill; and
  • The trading desk or other business unit that is establishing and responsible for the hedge.

• **Recordkeeping**: A banking entity must create and retain records meeting these requirements for a period that is no less than five years in a form that allows the banking entity to promptly produce such records to its regulator upon request.
Market Making Activities

The prohibition on proprietary trading does not apply to a banking entity’s market-making activities that meet the following requirements:

• The trading desk that establishes and manages the financial exposure:
  • routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure and
  • is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account in commercially reasonable amounts and throughout market cycles; and
• The amount, types, and risks of the financial instruments in the trading desk’s market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties.
Market Making Compliance Program

A banking entity must have a compliance program (extent, as with hedging, dependent upon its consolidated assets) for market making that includes written policies and procedures, internal controls, analysis and independent testing addressing:

• Instruments in which each trading desk will make a market;
• Actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure;
• Limits for each trading desk, based on the nature and amount of the trading desk’s market making-related activities;
• Internal controls and ongoing monitoring and analysis of each trading desk’s compliance with its limits; and
• Authorization procedures, including escalation procedures, that require review and approval of any trade that would exceed a trading desk’s limit(s).
Other Requirements

• **Compensation**: Compensation arrangements of persons performing market-making activities, as with hedging activities, are designed not to reward or incentivize prohibited proprietary trading.

  • Final Rule abandons a provision in the Proposed Rule that the activities of the trading desk, in order to be considered permitted market making, must be designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income rather than the appreciation in value of covered financial positions or hedging of such positions.

• **Registration**: Banking entity must be appropriately registered as a dealer, or exempt from registration or excluded from regulation as a dealer, under applicable securities or commodities laws.
Hedging Market Making Activities

- **Hedging**: Hedging in conjunction with market making activities (but not underwriting) is **not** subject to the hedging exemption requirements, **but**:
  - Hedge must still demonstrably reduce or otherwise significantly mitigate one or more specific risks;
  - Trading desk that is engaged in market making must also conduct or direct the hedge – hedges done by another trading desk are subject to the hedging exemption rule; and
  - Written policies and procedures addressing permissible hedging techniques and strategies for market making must specify how the trading desk may establish hedges, how such hedges are removed once the risk they are mitigating is unwound and the extent to which the trading desk will engage in anticipatory hedging.
Prudential Backstops

Permitted proprietary trading activities are not permissible under the Volcker Rule if:

• They would involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties;

• They would result in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or

• They would pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.
Section 619(b)(2)(B) of Dodd-Frank provides that the regulations required to be adopted shall be issued by:

- The appropriate Federal banking agencies, jointly, with respect to insured depository institutions;
- The FRB with respect to companies that control insured depository institutions, foreign banking organizations and nonbank financial companies supervised by the FRB; and
- The CFTC and SEC with respect to any entity for which the CFTC or the SEC, respectively, is the “primary financial regulatory agency” as defined in section 2 of Dodd-Frank.

CFTC is the primary financial regulatory agency with respect to, among others, futures commission merchants (FCMs) and swap dealers, but only with respect to their activities requiring FCM or swap dealer registration, respectively.
Who regulates?

Who is the banking entity’s regulator?

- CFTC Chairman Gensler noted in his statement of support for the Volcker Rule that the CFTC is the “primary financial regulatory agency” with respect to 110 swap dealers and FCMs, which include banking entities that are insured depository institutions as well as broker dealers registered with the SEC (for which the SEC is the primary financial regulatory agency for broker dealer activities).

- Comptroller of the Currency Curry stated that most banks subject to the rule “are large national banks supervised by the OCC and we will take the lead role in developing the supervisory plans.”

- Resource constraints at the CFTC likely will mean that the banking agencies and the SEC will have a greater role in ongoing supervision.

- Section 619(b)(2)(C) requires “consistent application and implementation” by the agencies of the Volcker rule.
Contact

Julian E. Hammar
Of Counsel
Morrison & Foerster LLP
2000 Pennsylvania Avenue, NW
Suite 6000
Washington, DC 20006-1888
(202) 887-1679
jhammar@mofo.com
About Morrison & Foerster

- We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life sciences companies. We’ve been included on The American Lawyer’s A-List for 10 straight years, and Fortune named us one of the “100 Best Companies to Work For.” Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com. © 2013 Morrison & Foerster LLP. All rights reserved. For more updates, follow Thinkingcapmarkets, our Twitter feed: www.twitter.com/Thinkingcapmkts.

- Because of the generality of this presentation, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.