A Closer Look

The Dodd-Frank Wall Street Reform and Consumer Protection Act

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Part of an ongoing series

The Volcker Rule Proposal:
A focus on proprietary trading

What now?

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There are no facts, only interpretations.

— *Friedrich Nietzsche*

The Financial Crisis Inquiry Commission cited a plethora of causes for the financial crisis. Proprietary trading, however, was not one of them. Notwithstanding the FCIC's findings—or lack thereof—the Federal Reserve, FDIC, OCC and SEC recently issued the long-awaited (and much leaked) proposed rule implementing the Volcker Rule (Section 619) of the Dodd-Frank Act. The Proposed Rule, which closely follows the language and presumptions spelled out in the Act, constructs the most far-reaching regulatory prohibition in US financial history by prohibiting proprietary trading not only in FDIC-insured institutions, but also in any affiliate thereof—irrespective of its business or geographic location (collectively defined as "banking entities"). On first read, the potential impact of the Proposed Rule is daunting, as it essentially requires covered institutions to demonstrate across all of their "principal" businesses that they are not engaging in impermissible proprietary trading. Not even Glass-Steagall went that far.

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The Proposed Rule also casts a very wide net. Preliminary agency estimates of the number of firms impacted by the Proposed Rule exceed 11,000. Moreover, in an attempt to level the playing field between US and non-US-based banks, the Proposed Rule has truly pushed the limits of extraterritorial reach—Volcker has gone global! In a surprise to many foreign banks, the Proposed Rule not only applies to their US branches and agencies (insured or uninsured) and their US affiliates, but it would also draw in their businesses located outside of the US to the extent that they engage in transactions which have a US nexus, defined very broadly. Dodd-Frank also authorizes the Federal Reserve to subject Nonbank SIFIs (Systemically Important Financial Institutions) that engage in activities prohibited by the Volcker Rule to capital requirements, activity limitations and reporting requirements. The Proposed Rule alludes to this provision, but does not address it because the Financial Stability Oversight Council has yet to formally identify any Nonbank SIFIs that could be subject to the provision.

This *A Closer Look* focuses primarily on the proprietary trading aspects of the Proposed Rule—we will cover the fund aspects of the Proposed Rule in a future A Closer Look. Our objective here is not to provide a detailed analysis of the Proposed Rule, but rather to try and help answer the broader question, "What should I do now?"

Remember this is a "Proposed" Rule, so while it is important to ensure that your firm is prepared to address its requirements, the scope and impact of Volcker is a politically charged topic both domestically and globally and the Proposed Rule will be the subject of lengthy debate and possible modifications or interpretations that could be significant. At a minimum, there are three things that every banking entity should focus on at this time.

No.1 – Get organized around your response

Make sure your voice is heard before the rule is finalized

The Proposed Rule—explained and set forth in a release running nearly 300 pages—while resolving some issues, generally stays close to the language and presumptions of Section 619. In some cases, the proposal includes interpretations that arguably make the scope of the prohibitions broader, as with the impact on foreign firms and activities. The substantial disconnect between the language and presumptions of the Proposed Rule and how capital markets actually work in practice is evidenced by the approximately 400 topics and 1300 questions raised by the Agencies in the Proposed Rule—an unprecedented number for any financial regulatory rule-making. To their credit, the Agencies ask again and again in their questions about the impact the Proposed Rule will have on firms and the markets they participate in—especially a firm's willingness to continue to provide market-making and other services.

The Agencies' myriad of questions basically boil down to a single question, "Is there any way to write these rules so that they meet the requirements of Dodd-Frank while not significantly impairing the functioning of our capital markets?"

The comment period on the Proposed Rule ends on January 13, 2012 and it will be very important for firms to comment on the issues most critical to their business. As seen with the FDIC and Federal Reserve's "Living Wills" final rule, the regulators are receptive to industry input and much can change between the proposed and final rule. There are several actions you may want to take now to ensure that you implement an effective approach to responding to the Proposed Rule:

- Implement a formal and organized approach to consider and address each of the 1300 questions in the Proposed Rule that are applicable to your business.
- Involve the trading desks and key support functions (e.g. collateral management, finance) in your analysis of the impact of the Proposed Rule on your firm. The granular nature of the Rule's requirements and the impact on various desks and strategies can truly only be evaluated at the desk level. Foreign banks should assess the potential impact of the Proposed Rule on their activities outside of the US and whether they can comply with the very narrow exemption for trading "solely outside of the US."
- Coordinate the approaches of your Legal and Government Affairs functions to assess which issues are unique to your firm and critical to address in a comment letter. While some broad industry-wide issues can be addressed by industry group comment letters, we believe that firms should individually comment on the specific impact of the Proposed Rule on their organizations, their customers and their involvement in the market. As many of the Proposed Rule's provisions are mandated by Dodd-Frank and the regulators are clearly seeking alternatives, firms should take a constructive, "if not this, then what?" approach to their comments.
- Given the time compression between the close of the comment period in January 2012 and the July 2012 statutory effective date, firms should comment on the need for an implementation transition period for the compliance program and reporting requirements simply as a practical necessity. In addition, firms should ensure that they address issues such as the time and resources needed to mobilize on the requirements of the final rule (e.g., business re-engineering, infrastructure development and building reporting capacity).

No. 2 – Conduct a detailed assessment of your trading businesses—desk by desk—through the lens of the Proposed Rule

A granular understanding of unbundled trading activities and related revenues and expenses is essential—and the results can be surprising

Firms engaged in market making and related trading activities have established businesses with recurring activities that span an array of functions, products, services and activities from market research to price discovery, transaction structuring, portfolio management, funding, trade clearing and execution. Distinguishing proprietary trading activities in and from this business model is the most challenging aspect of the Proposed Rule. In particular, running throughout the Volcker Rule is the presumption that acting as "principal" is "speculating," except when the Rule says it is not. In so doing, the Proposed Rule ends up consigning much of the US financial services industry to a process of having to demonstrate that any trading activity as principal—including specifically market-making, underwriting, hedging, and customer-driven transactions—is not proprietary trading, by qualifying for an explicit exemption under the Proposed Rule or, in some cases, by documenting the non-speculative purpose. Covered banking entities that act as principal in the capital markets are thus presumed to engage in speculation unless they can prove otherwise.

A practical challenge of the Volcker Rule is the absence of a clear means to distinguish taking principal market risk from speculative proprietary trading or investing risks. Taking principal market risk is necessary to, and inseparable from, market-making and other essential trading activities such as price discovery and providing liquidity and customized services to customers. These activities are intrinsic to safe and sound trading when exercised within risk tolerances commensurate with a firm's market activities and

infrastructure, and are not exclusive indicators of a proprietary desk or strategy. The Proposed Rule could significantly change the economics of firms' capital markets and trading businesses and more importantly, negatively affect market liquidity, price transparency and the efficient operation of the financial markets.

We believe that firms' derivatives and Fixed Income businesses will be the most significantly impacted areas and will require the most change to the business model if the rule is implemented as proposed. The Proposed Rule's likely impact on businesses that deal in exchange traded products—such as equities —will be comparatively less given that prices are transparent to the market and there is substantially less inventory that is held in anticipation of a client transaction. That said, derivatives activities of those businesses, such as correlation and arbitrage trading, may have to change to remain a permitted activity.

Firms will need to unbundle their trading activities and related services to fully understand the associated revenues, expenses and associated risks to help distinguish permissible activities. There are several actions that you should be taking now to help inform your response to the Proposed Rule and prepare for compliance in the future:

- Using the definitions of market making and proprietary trading included in the Proposed Rule, to more closely analyze the revenue strategies employed across your capital markets and trading businesses. Focusing a critical eye on exactly which components of the business are dependent on customer flow transactions versus positioning with a market view will help you to understand your vulnerability to the Proposed Rule.
- Given the specific strategy of a trading desk or unit, evaluate how revenue is "really" earned. The analysis of how you make money in your trading activities will be critical to the determination of which trading units may be most vulnerable to being considered as engaged in impermissible proprietary trading activities. The Financial Stability Oversight Council (FSOC) Report on the Volcker Rule, released in January 2011, included several factors/tests designed to help firms distinguish permitted market-making from prohibited proprietary trading (the Proposed Rule includes similar factors/tests). Several firms applied the tests included in the FSOC study to certain trading desks and were very surprised as to how much trading revenues relied on the positive market impact of existing positions or inventory.
- Review and analyze risk management data and evaluate such information in light of current state trading strategies. For example, high levels of inventory with low turnover or long holding periods are particularly at risk. Further, high VaR limits for customer and market making business may, according to the Proposed Rule, be indicative of proprietary trading.
- Identify and evaluate the types of data that can be used from your front, middle and back office systems that may be helpful in profiling the various trading businesses. For example, how efficiently and accurately can you decipher which trades are customer trades, hedging trades, or market liquidity transactions? Further, can you, with accuracy, determine what portion of the profit in the transaction was attributable to the mark-up for sale or the holding period? This information will be critical to your initial analysis, but also to the ongoing monitoring, reporting and compliance which is required under the Proposed Rule. In this regard, firms may want to provide comments on meaningful metrics that are comparable across market participants and that can be reasonably operationalized.

- Determine whether your firm may need to change its compensation agreements. The Proposed Rule provides that compensation incentives for permissible trading activities should not be based on what the Proposed Rule considers to be proprietary risk-taking. As written, we believe these strict requirements would differ significantly from the more holistic measurements utilized by most firms today.

No. 3 – Don't ignore the effective date

Make sure you understand what it will take to implement the compliance and reporting requirements by July 2012

As difficult as the maze of regulations and guidance is to navigate, what is of great concern to major firms subject to the rule is the special reporting and compliance obligations that the Proposed Rule would impose on larger firms (with over $1B in trading assets and liabilities—with even more significant requirements on firms with over $5B) effective on July 21, 2012. While a rule-making involving five different federal regulatory agencies and 1300 questions will face daunting challenges to complete within six months, the July 21, 2012 effective date is statutorily mandated, so if you haven't learned the lesson by now—don't assume you know how this will end.

Some elements of the Proposed Rule—such as the compliance and reporting requirements—are likely to go into effect in some form by the effective date. Moreover, while the Proposed Rule indicates that there will be a two-year conformance period for impermissible activities and investments, the preamble to the proposal also emphasizes that banking entities with non-conforming activities and investments will be expected to bring them into conformity as soon as possible after the effective date, which generally means, except in exceptional circumstances—comply immediately. For now:

- Determine what your firm will have to develop in the way of reporting and recordkeeping systems to generate the daily and other trade reporting required by the various metrics if your organization has over $1B in trading assets and liabilities. Determine whether you can generate this information at the desk level, an intermediate level and at an aggregate reporting level(s).
- Identify which activities and investments may not conform to the requirements of the Rule and develop a plan to conform those activities as quickly as possible.

The bottom line is that it looks like the Volcker Rule is here to stay, but perhaps not in the exact form as proposed. Its final form will—at least in part—be shaped by the response of the industry to the questions asked in the Proposed Rule and by the US and global political environment as the final rules are being drafted. Firms should not overreact, but be proactive and armed with quantitative data in their response to the Proposed Rule and diligent and thoughtful in preparing for the potential impact of the final rule on their firm and their business.

Additional information

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