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Final Volcker Rule

Davis Polk & Wardwell LLP

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Davis Polk

Final Volcker Rule

December 23, 2013

FLOWCHARTS: PROP TRADING



These Davis Polk flowcharts are designed to assist banking entities in identifying permissible and impermissible proprietary trading activities under the final regulations implementing the Volcker Rule, issued by the Federal Reserve, FDIC, OCC, SEC and CFTC on December 10, 2013. An introduction to the new compliance requirements is also included.

To make our summary and analysis of the final rules more user-friendly, these flowcharts graphically map the key restrictions on covered trading activities in lieu of a traditional law firm memo.

Davis Polk flowcharts analyzing the Volcker Rule's prohibition on banking entities sponsoring or acquiring ownership interests in hedge funds and private equity funds will be available at www.volckerrule.com.

Step 1 IS THE BANKING ENTITY ENGAGED IN PROPRIETARY TRADING UNDER THE VOLCKER RULE?

- IS A BANKING ENTITY TRADING? 2
- DOES THE ACTIVITY OR TRANSACTION INVOLVE A PURCHASE OR SALE OF ONE OR MORE FINANCIAL INSTRUMENTS? 3
- IS THE BANKING ENTITY TRADING AS PRINCIPAL FOR A TRADING ACCOUNT? 4
- IS AN EXCLUSION FROM PROPRIETARY TRADING AVAILABLE? 5

Step 2 IS THE TRADING PERMITTED UNDER THE VOLCKER RULE?

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Volcker Rule Final Regulations: Proprietary Trading Overview



Step
1

SLIDES 2 TO 5

IS A BANKING ENTITY ENGAGED IN PROPRIETARY TRADING UNDER THE VOLCKER RULE?

- Is a **banking entity** trading? →
- Does the activity or transaction involve a purchase or sale of one or more **financial instruments**? →
- Is the entity trading as principal for a **trading account**? →
- Is an **exclusion** from proprietary trading available? →

ACTIVITY IS NOT PROPRIETARY TRADING AND IS NOT WITHIN THE SCOPE OF THE VOLCKER RULE

NO (OR IF AN EXCLUSION IS AVAILABLE)

YES (OR IF NO EXCLUSION IS AVAILABLE)

Step
2

SLIDES 6 TO 15

IS THE TRADING PERMITTED UNDER THE VOLCKER RULE?

<ul style="list-style-type: none"> ▪ Market Making-Related Activities → ▪ Underwriting Activities → ▪ Risk-Mitigating Hedging Activities → 	<ul style="list-style-type: none"> ▪ Trading in Government Obligations → → ▪ Trading on Behalf of Customers → ▪ Trading by a Regulated Insurance Company → ▪ Trading Activities of Foreign Banking Entities Outside the United States →
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ACTIVITY IS IMPERMISSIBLE PROPRIETARY TRADING

NO

YES

Step
3

SLIDE 16

IS THE ACTIVITY PRECLUDED BY A BACKSTOP PROHIBITION?

Does the activity:

- Involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties? →
- Result in a material exposure by the banking entity to high-risk assets or trading strategies? →
- Pose a threat to the safety and soundness of the banking entity or U.S. financial stability? →

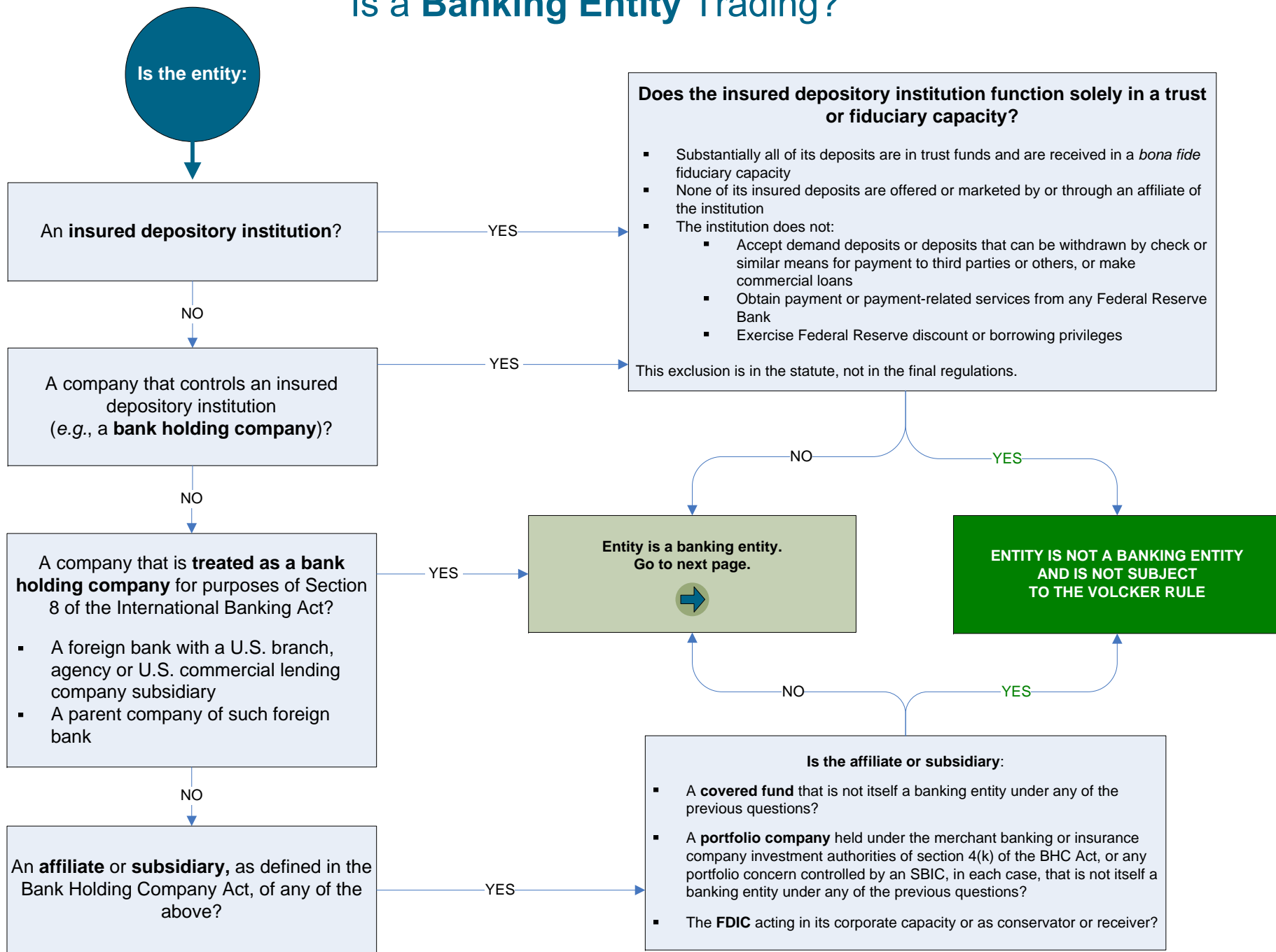
Tiered compliance program and reporting requirements apply

SLIDES 18-24

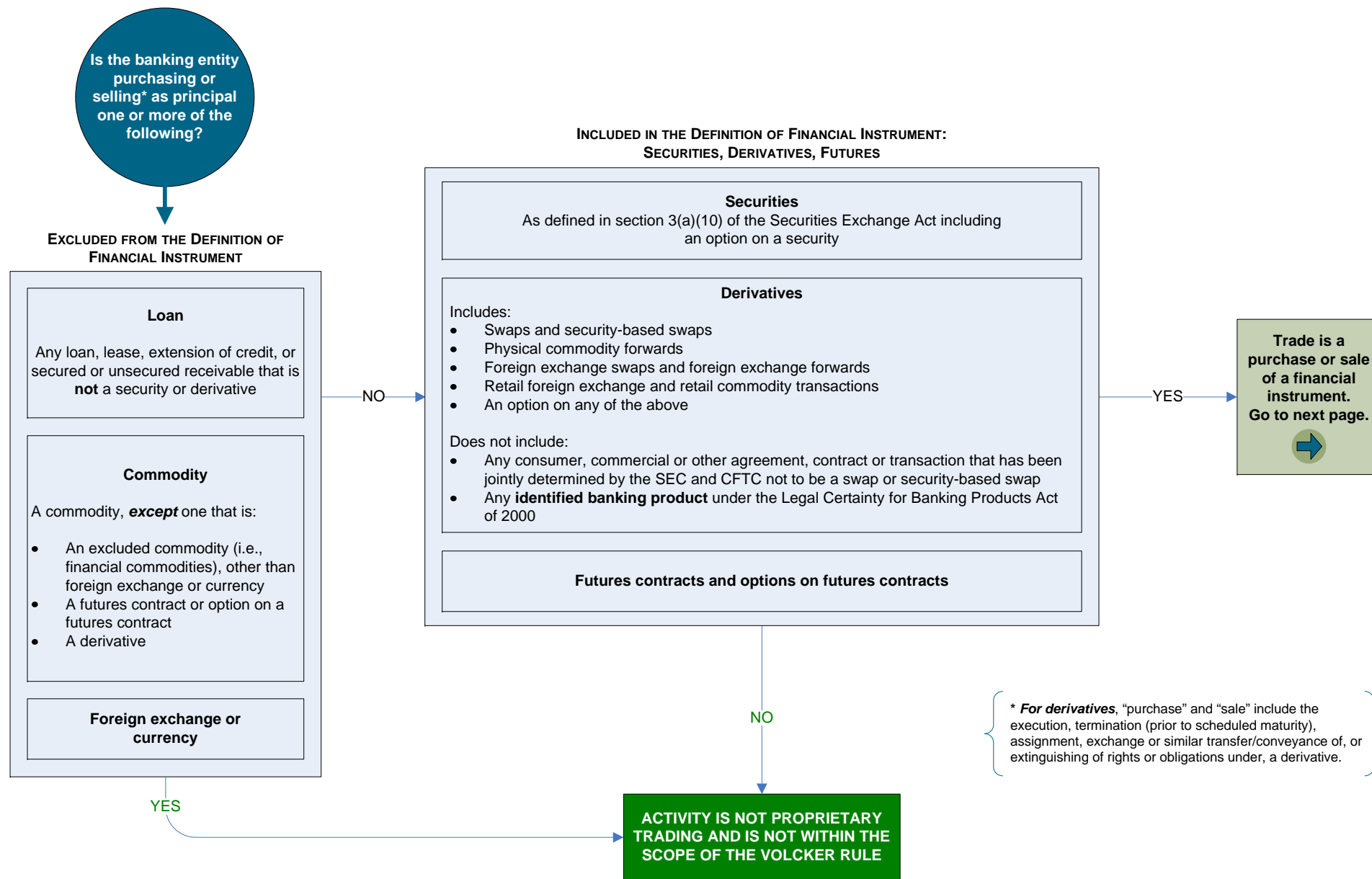
ACTIVITY IS PERMITTED PROPRIETARY TRADING

NO

YES



Does the Activity or Transaction Involve a Purchase or Sale of One or More Financial Instruments?



Is the Banking Entity Trading as Principal for a Trading Account?

***Account** does not refer to an account in the normal business or accounting sense. The preamble notes that trading account is nomenclature for the set of transactions that are subject to the restrictions on proprietary trading.

Does the activity meet any of the following tests?

PURPOSE TEST

Is the **account*** used to purchase or sell one or more financial instruments **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** that a trade is for a trading account arises if the banking entity:

- holds the instrument for **fewer than 60 days**, or
- substantially transfers its risk within 60 days.

STATUS TEST

Regardless of purpose, does the banking entity meet either of the following descriptions?

- The banking entity is **licensed or registered** to engage in the business of a **dealer**, a **swap dealer**, or a **security-based swap dealer** (or required to be).
- The banking entity **engages in the business of a dealer, swap dealer or security-based swap dealer outside of the United States.**

AND

The financial instrument is purchased or sold in connection with the activities that require the banking entity to be licensed/registered as a dealer or are in connection with the activities of such business outside the United States, as relevant.

MARKET RISK CAPITAL RULE TEST

If the banking entity, or any affiliate of the banking entity, is an insured depository institution, a bank holding company or a savings and loan company that is subject to the U.S. banking agencies' market risk capital rule, is the account used to purchase or sell financial instruments that are **both market risk capital rule covered positions and trading positions** (or hedges of such positions)?

ACTIVITY IS NOT PROPRIETARY TRADING AND IS NOT WITHIN THE SCOPE OF THE VOLCKER RULE

NO TO ALL THREE QUESTIONS

YES TO ANY QUESTION

Entity is trading as principal for a trading account. Go to the next page.

Is an **Exclusion** from Proprietary Trading Available?



Does the purchase or sale meet any of the following criteria?

REPO AND REVERSE REPO

Repo or reverse repo pursuant to which the banking entity has simultaneously agreed, in writing, to both purchase and sell a stated asset, at a stated price and on stated dates or on demand with the same counterparty.

SECURITIES LENDING

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.

LIQUIDITY MANAGEMENT PLAN

Purchase or sale of a security for the purpose of **liquidity management** in accordance with a documented liquidity management plan of the banking entity.

DCO/CLEARING AGENCY TRANSACTIONS

By a banking entity that is a **derivatives clearing organization** or a **clearing agency** in connection with clearing financial instruments.

LIMITED CLEARING MEMBER ACTIVITIES

By a banking entity that is a member of a **clearing agency, derivatives clearing organization** or **designated financial market utility**, in specified circumstances.

SATISFY AN EXISTING DELIVERY OR LEGAL OBLIGATION

To satisfy:

- an **existing delivery obligation** of the banking entity or its customers, including to prevent or close out a failure to deliver.
- an obligation of the banking entity in connection with a **judicial, administrative, self-regulatory organization or arbitration proceeding**.

ACTING AS AGENT, BROKER OR CUSTODIAN

Acting solely as **agent, broker or custodian**.

EMPLOYEE COMPENSATION PLANS

Through a **deferred compensation, stock-bonus, profit-sharing or pension plan of the banking entity** that is established in accordance with the law of the United States or a foreign sovereign, if the purchase or sale is made directly or indirectly by the banking entity **as trustee** for the benefit of persons who are or were employees of the banking entity.

DEBT PREVIOUSLY CONTRACTED

In the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the financial instrument as soon as practicable, and does not retain such investment for longer than the period permitted by its primary regulatory agency.

Is the banking entity trading in accordance with a documented liquidity management plan that meets specified requirements?

These circumstances include any purchase or sale:

- necessary to correct trading errors made by or on behalf of a customer;
- in connection with and related to the management of a default or threatened imminent default of a customer;
- in connection with and related to the management of a default or threatened default of the clearinghouse or financial market utility;
- in connection with and related to the management of a default or threatened default of another member of the clearinghouse or financial market utility; or
- required by the rules of the clearinghouse or financial market utility to mitigate the risk resulting from the clearing by a member of security-based swaps that reference the member or an affiliate of the member.

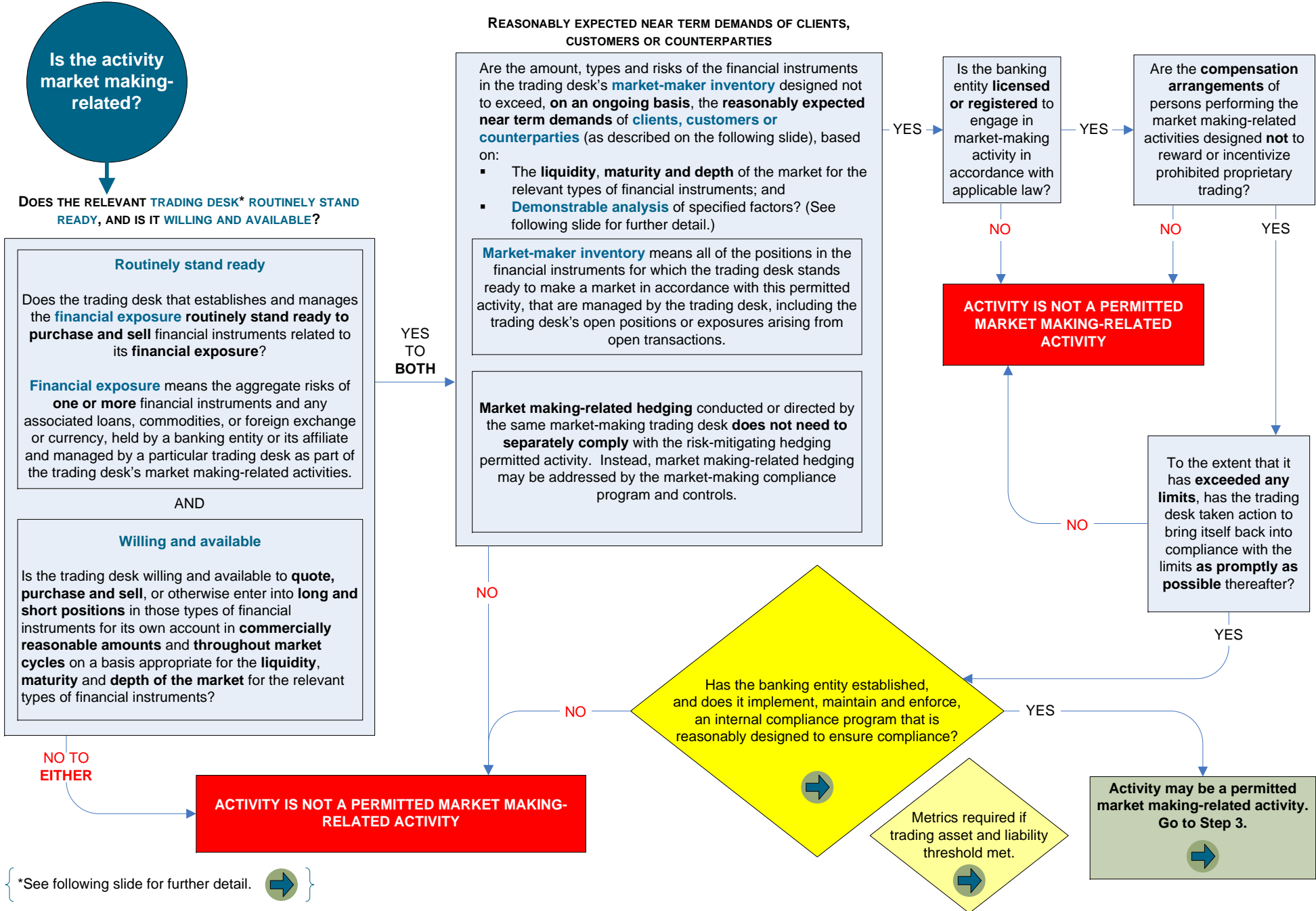
YES TO ANY QUESTION

ACTIVITY IS NOT PROPRIETARY TRADING AND IS NOT WITHIN THE SCOPE OF THE VOLCKER RULE

The trading activity is proprietary trading within the scope of the Volcker Rule. Go to Step 2.

NO TO ALL QUESTIONS

Step 2A-1: Permitted Activities: Market Making-Related



*See following slide for further detail.

Permitted Activities: Market Making-Related Key Terms and Concepts



CLIENT, CUSTOMER OR COUNTERPARTY

For the market making-related permitted activity, **client, customer or counterparty** refers to market participants that make use of the banking entity's market making-related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services.

A trading desk may engage in **interdealer trading** to meet the reasonably expected near term demands of its clients, customers or counterparties, including current demand, unwind or sell positions acquired from clients, customers or counterparties, or engage in risk-mitigating or inventory management transactions. However, a trading desk or other organizational unit of another banking entity is not a client, customer or counterparty of the trading desk if that other entity has **trading assets and liabilities of \$50 billion or more**, unless:

- the trading desk **documents how and why** a particular trading desk or other organizational unit of the entity should be treated as a client, customer, or counterparty of the trading desk for purposes of market making-related permitted activity; **or**
- the purchase or sale by the trading desk is conducted **anonymously** on an **exchange or similar** trading facility that permits trading on behalf of a broad range of market participants.

The preamble states that interdealer trading **will bear some scrutiny by the Agencies**.

INTERDEALER TRADING

TRADING DESK

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 its affiliates. Trading desk does **not** capture multiple levels in the organization.

In order to perform market making analysis, a firm must first identify all relevant trading desks that may be ready to engage in permitted market-making activities.

PRIMARY DEALERS AND EXCHANGE TRADED FUNDS (ETFs)

The preamble notes that primary dealer activities and ETF authorized participant activities **should be able to rely** on the market making-related permitted activity **to the extent** the underwriting permitted activity is not available.

DEMONSTRABLE ANALYSIS

Demonstrable analysis must cover the following factors: **historical customer demand, current inventory** of financial instruments, and **market and other factors** regarding the amount, types and risks of or associated with financial instruments in which the trading desk makes a market, **including through block trades**.

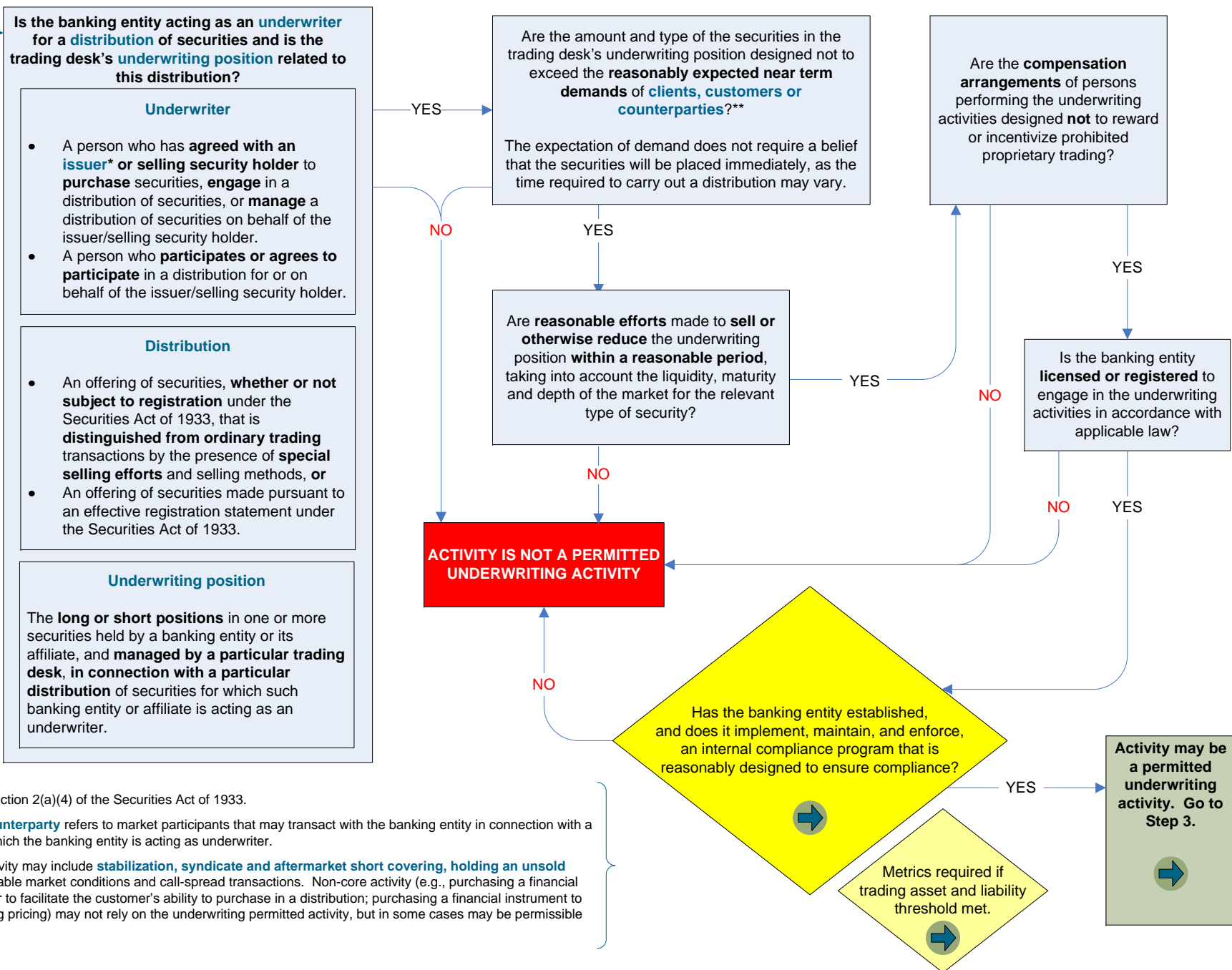
ARBITRAGE

A trading desk would not qualify for the market-making exemption if it is **wholly or principally engaged** in arbitrage trading or other **trading that is not in response to, or driven by,** the demands of clients, customers or counterparties.

Step 2B: Permitted Activities: Underwriting



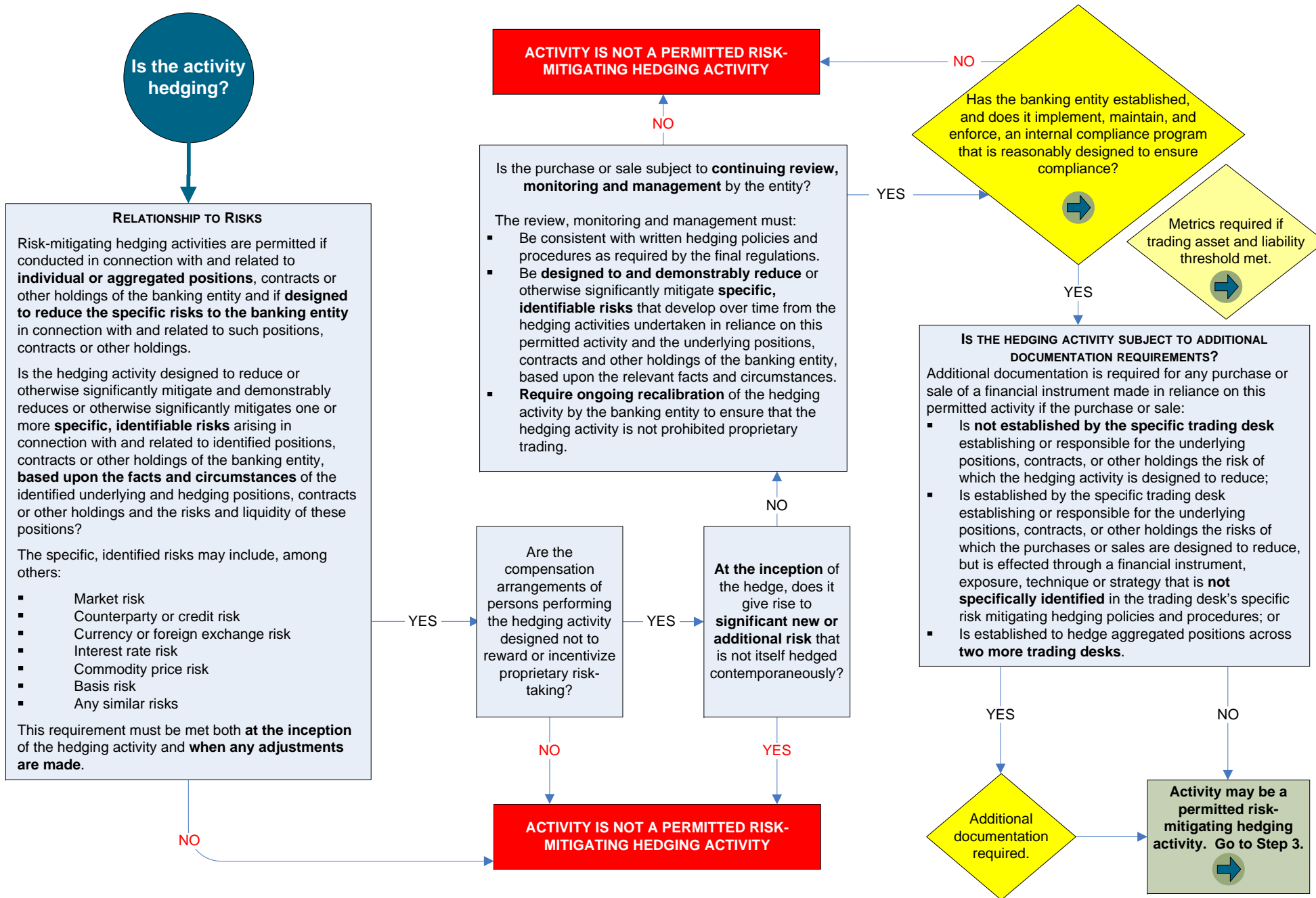
Is the activity underwriting?

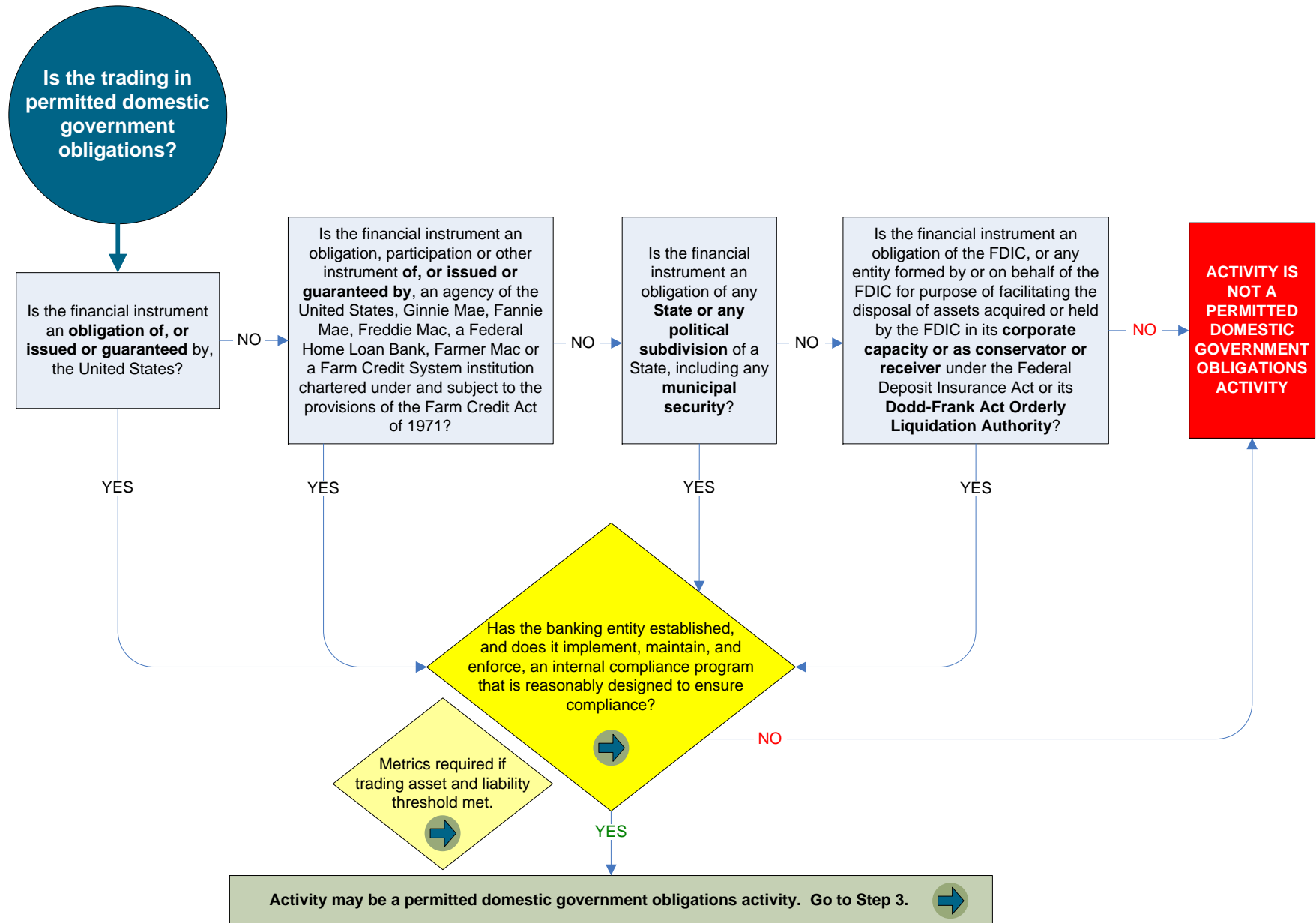


* **Issuer** is defined as in Section 2(a)(4) of the Securities Act of 1933.

** **Client, customer or counterparty** refers to market participants that may transact with the banking entity in connection with a particular distribution for which the banking entity is acting as underwriter.

Underwriting permitted activity may include **stabilization, syndicate and aftermarket short covering, holding an unsold allotment** due to impracticable market conditions and call-spread transactions. Non-core activity (e.g., purchasing a financial instrument from a customer to facilitate the customer's ability to purchase in a distribution; purchasing a financial instrument to help determine underwriting pricing) may not rely on the underwriting permitted activity, but in some cases may be permissible under other exceptions.

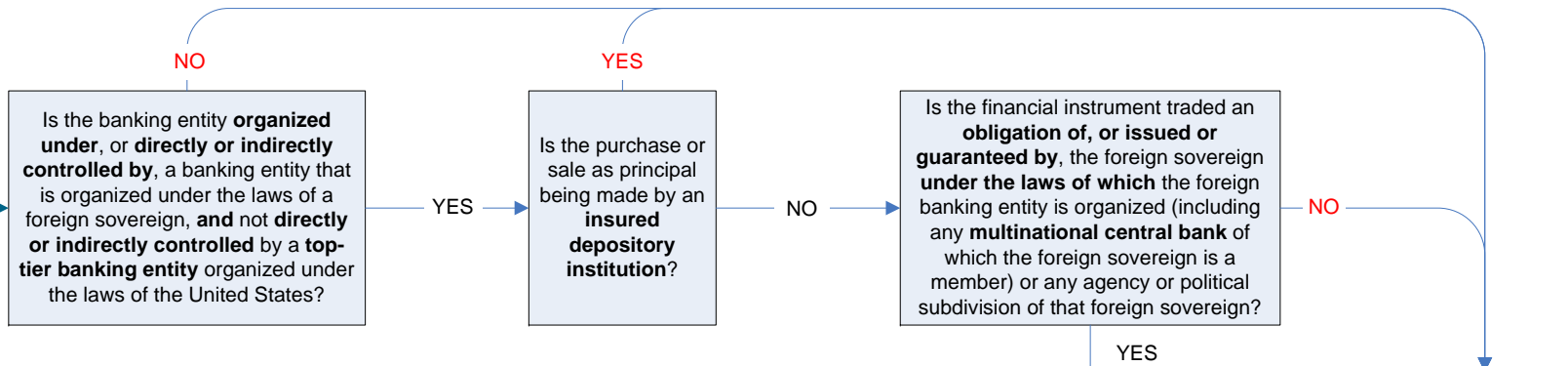




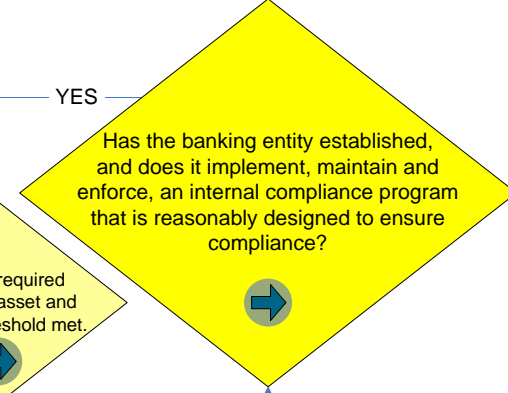
Step 2D-2: Permitted Activities: Foreign Government Obligations



**U.S. AFFILIATES OF
FOREIGN BANKING
ENTITIES
(AND FOREIGN BANKING
ENTITIES)**

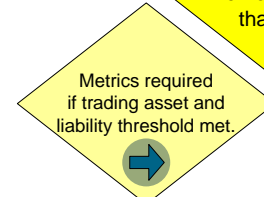
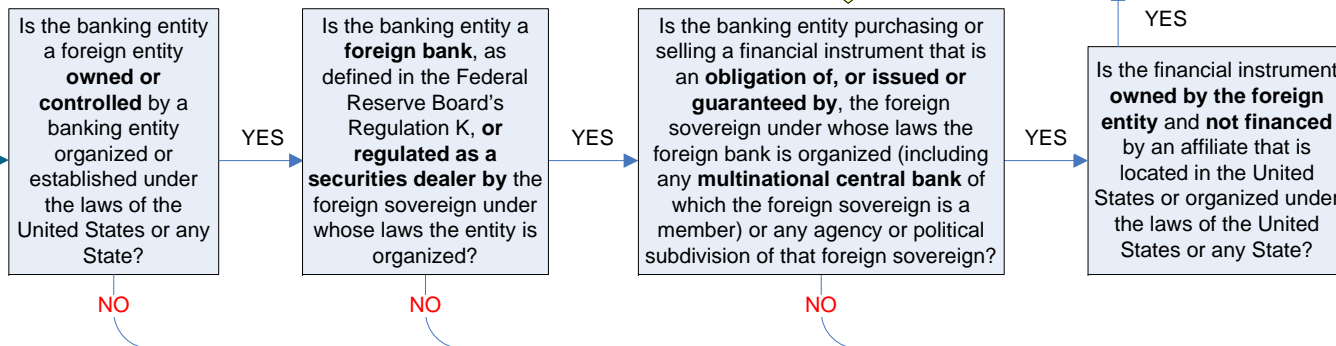


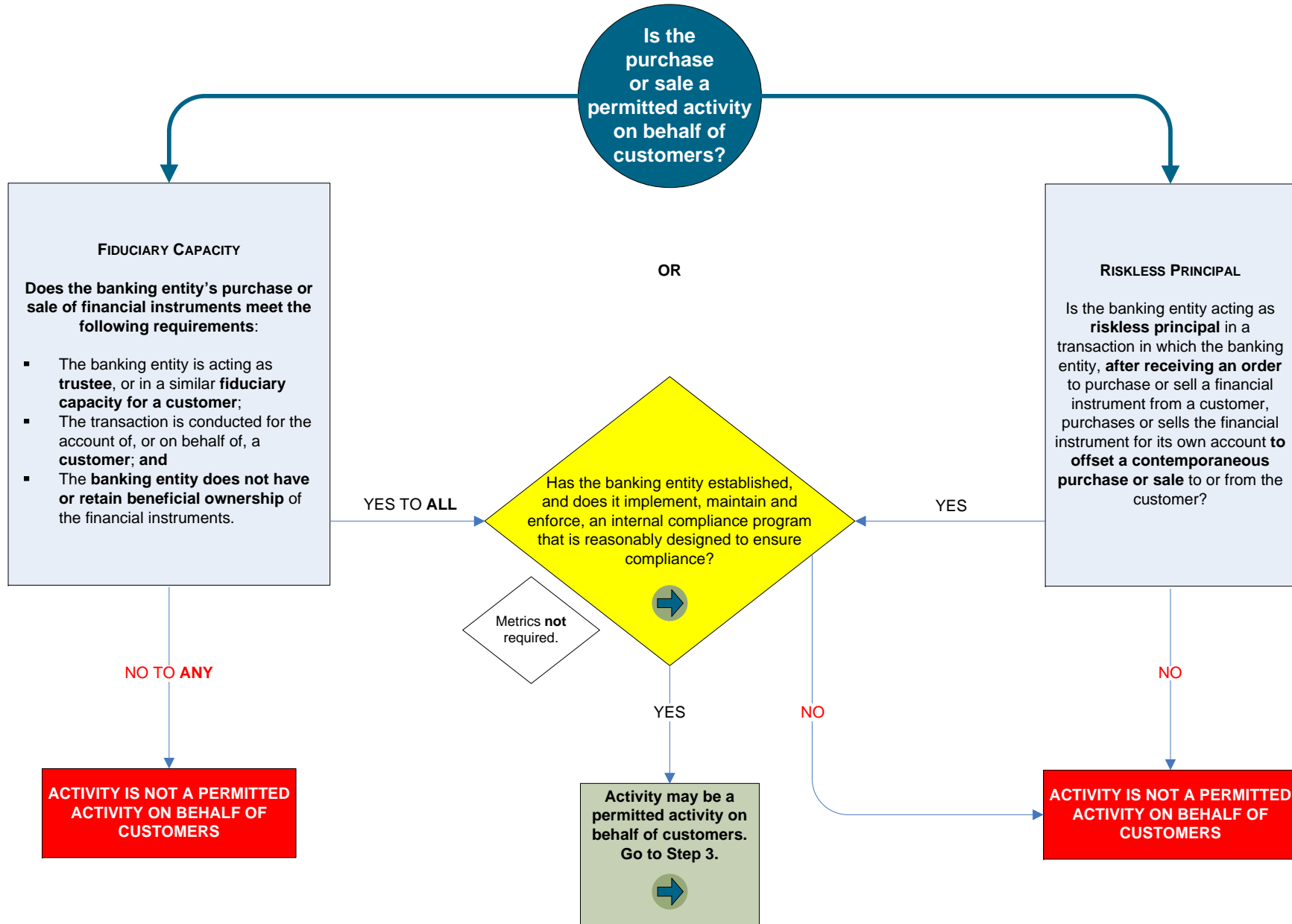
Activity may be a permitted foreign government obligations activity. Go to Step 3.

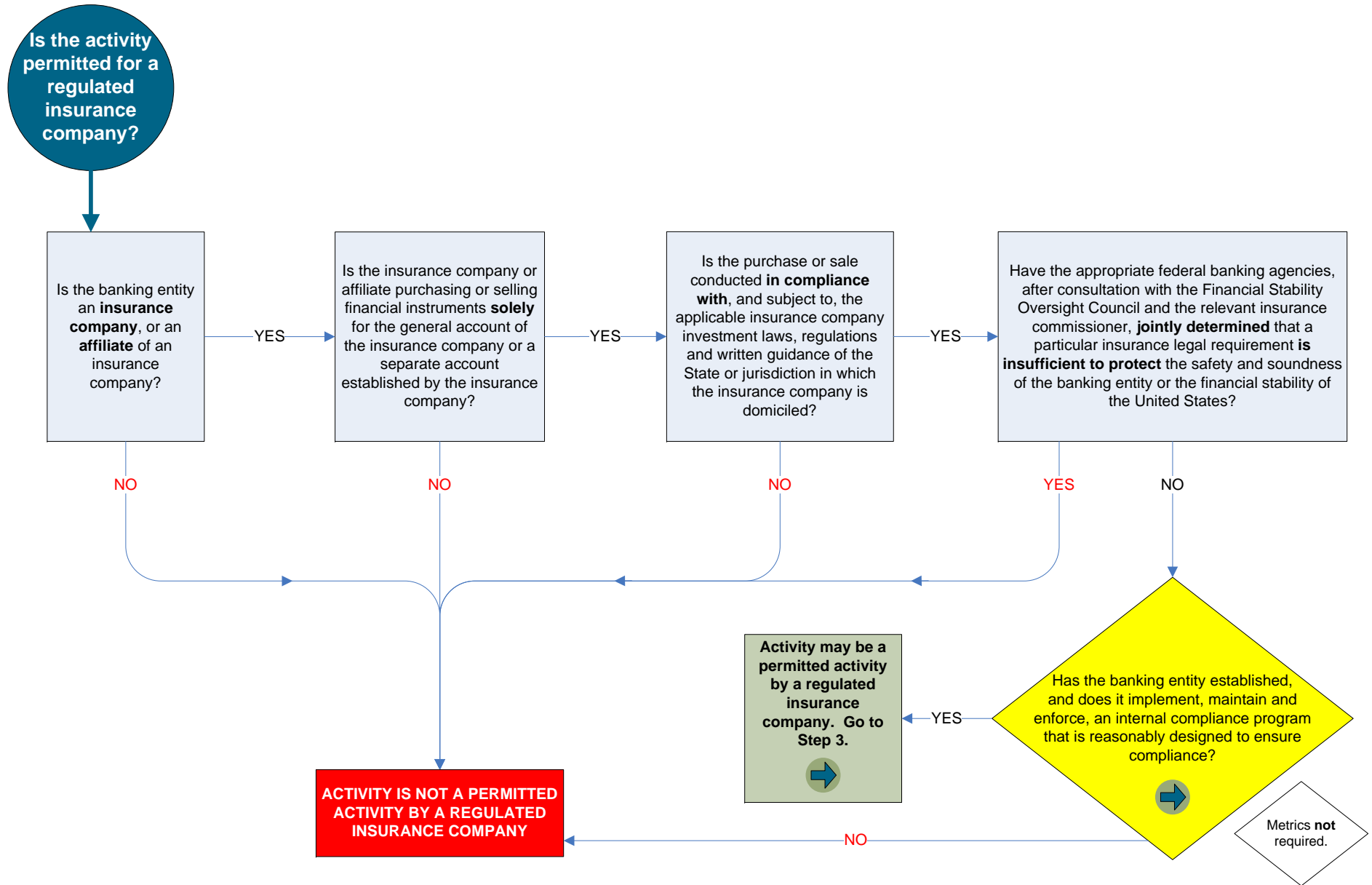


ACTIVITY IS NOT A PERMITTED FOREIGN GOVERNMENT OBLIGATIONS ACTIVITY

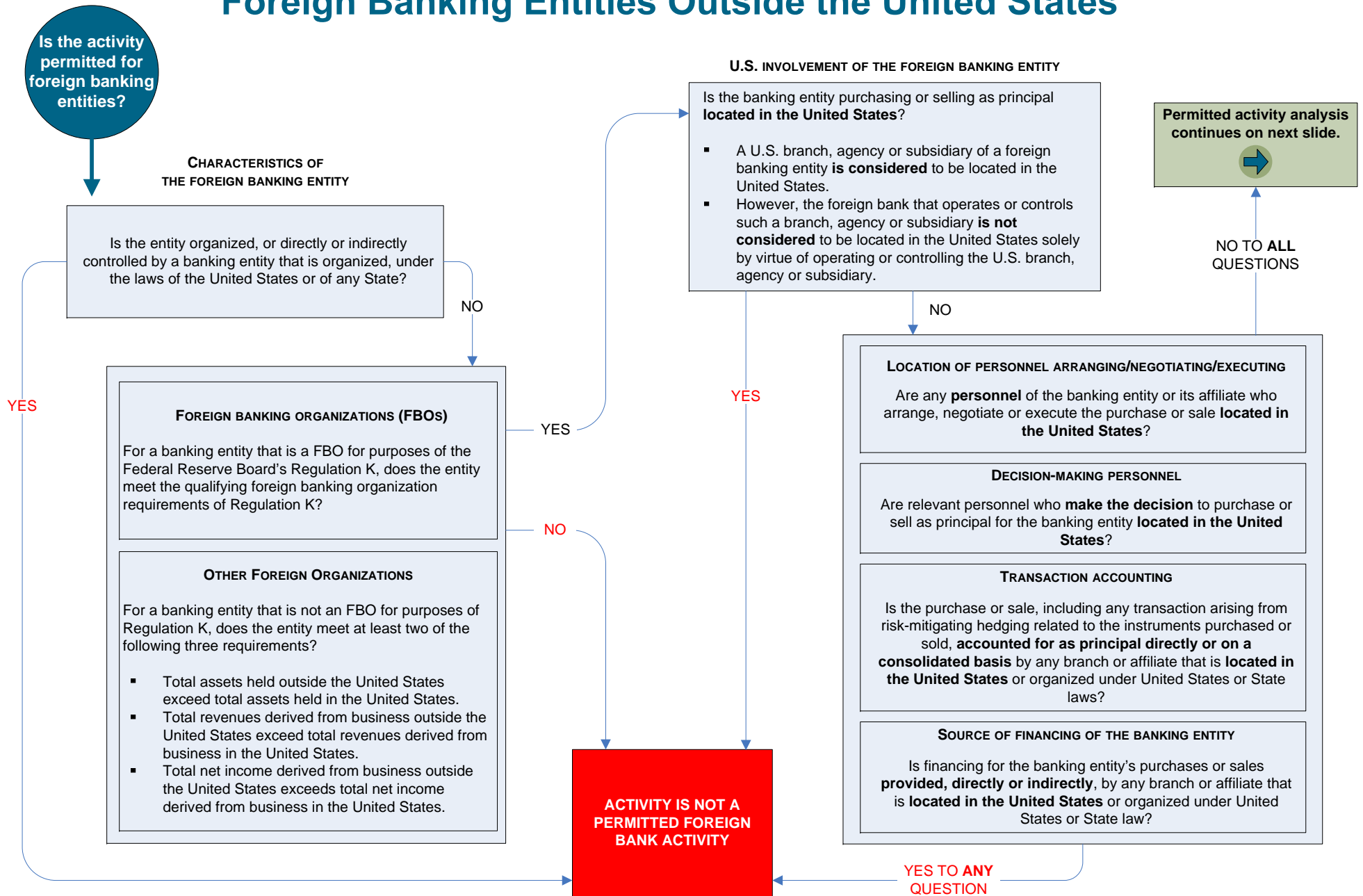
**FOREIGN AFFILIATES OF
A U.S. BANKING ENTITY
(BUT NOT FOREIGN
BRANCHES OF U.S.
BANKING ENTITIES)**







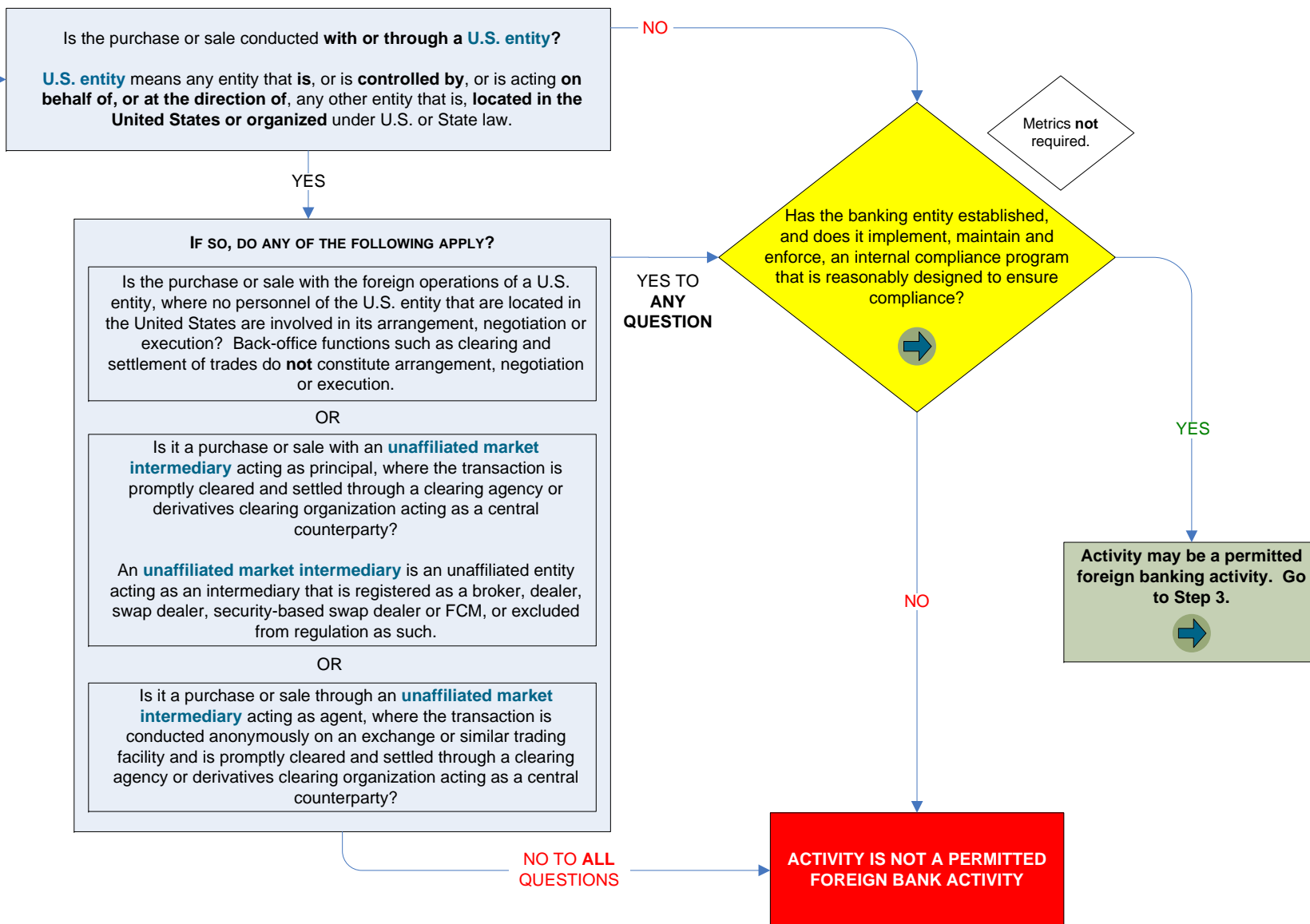
Permitted Activities: Trading Activities of Foreign Banking Entities Outside the United States



Permitted Activities: Trading Activities of Foreign Banking Entities Outside the United States

POTENTIAL U.S. INVOLVEMENT OF THE COUNTERPARTY

CONTINUED FROM PREVIOUS SLIDE





Would the activity otherwise be precluded?

MATERIAL CONFLICTS OF INTEREST
 Would the transaction, class of transactions, or activity involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions or activity?

**EXCEPTION 1
 TIMELY AND EFFECTIVE DISCLOSURE**
 Does either one of the following remedial measures apply?
 Before effecting the specific transaction or class or type of transactions, or engaging in the specific activity, has the banking entity:

- Made 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
- Made such disclosure 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 of interest?

**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?
 The banking entity **may not rely** on information barriers if it **knows or reasonably should know** that notwithstanding, the conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty.

MATERIAL HIGH-RISK EXPOSURES
 Would the transaction, class of transactions or activity 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 pose a threat to the financial stability of the United States.

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 pose a threat to the financial stability of the United States.

THREAT TO SAFETY AND SOUNDNESS
 Would the transaction, class of transactions or activity pose a threat to the **safety and soundness** of the banking entity or the financial stability of the United States?

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

ACTIVITY IS PERMITTED

Prop Trading Compliance Requirements

Preliminary Overview

Table of Contents



The Volcker Rule contains an extensive compliance program and, for some banking entities, metrics reporting. This section of the document outlines the Volcker Rule's most important compliance-related provisions.

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ALL COMPLIANCE PROGRAMS MUST, AT A MINIMUM, INCLUDE:

INTERNAL POLICIES AND PROCEDURES

Written policies and procedures reasonably designed to document, describe, monitor and limit exempted trading activities conducted by the banking entity (including setting, monitoring and managing **limits** required under the market making-related, underwriting and risk-mitigating hedging permitted activities) to ensure that all activities comply with the Volcker Rule.

INTERNAL CONTROLS

A **system of internal controls reasonably designed** to monitor compliance and to prevent the occurrence of activities that are prohibited by the Volcker Rule.

MANAGEMENT FRAMEWORK—RESPONSIBILITY AND ACCOUNTABILITY

A **management framework that clearly delineates responsibility and accountability** for compliance with the Volcker Rule and that includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified in the Volcker Rule or by management as requiring attention.

INDEPENDENT TESTING

Independent testing and audit of the effectiveness of the compliance program conducted periodically by **qualified personnel** of the banking entity **or by a qualified outside party**.

TRAINING

Training for trading personnel and managers, as well as **other appropriate personnel**, to effectively implement and enforce the compliance program.

RECORDKEEPING

Records sufficient to demonstrate compliance with the Volcker Rule, which a banking entity must promptly provide to regulators upon request and retain for a period of **no fewer than 5 years** or such longer period as required by regulators. This must include the specified records required to be maintained in connection with the additional document requests for risk-mitigating hedging permitted activity, as applicable.

The terms, scope and detail of the compliance program must be **appropriate for the types, size, scope and complexity of the activities and business structure** of the banking entity.

BANKING ENTITIES SUBJECT TO THE ENHANCED PROGRAM REQUIREMENT UNDER APPENDIX B OF THE FINAL RULE AND/OR METRICS REPORTING MUST SUPPLEMENT THE STANDARD PROGRAM WITH ADDITIONAL REQUIREMENTS.



ENHANCED COMPLIANCE PROGRAMS FOR PROPRIETARY TRADING MUST:

- **Identify, document, monitor and report** permitted trading activities, and promptly address risks and potential areas of noncompliance and prevent activities prohibited by, or that do not comply with, the Volcker Rule.
- **Establish and enforce appropriate limits** on covered trading activities, including limits on the size, scope, complexity and risks of the individual activities.
- Provide for periodic **independent review and testing** and ensure the internal audit, corporate compliance and internal control functions are effective and independent.
- Make **senior management** and others, as appropriate, **accountable** and ensure review of the compliance program by the **Board and CEO** (or equivalent).
- **Facilitate** supervision and examination by regulators of permitted activities.

REQUIREMENTS FOR COMPLIANCE PROGRAMS FOR PROPRIETARY TRADING

A banking entity must **establish, maintain and enforce a compliance program** that includes written policies and procedures that are appropriate for the types, size, and complexity of, and risks associated with, its permitted trading activities. Adequate resources and knowledgeable personnel must be used, and the program must be updated with a frequency sufficient to account for changes in activities, testing results, identification of weaknesses and legal/regulatory/other changes. Must provide for revision before expanding trading activities.

TRADING DESKS: A banking entity must have **written policies governing each trading desk** that include descriptions of the financial instruments the desk may purchase and sell, the type of trading activity the desk may conduct, the risks that the desk may take on, and other information relating to the desk's trading activities.

DESCRIPTION OF RISKS AND RISK MANAGEMENT PROCESSES: The compliance program must include a comprehensive **description of the entity's risk management** program. This must include a description of the governance, approval, reporting, escalation, review and other extensive procedures used to ensure compliance with the Volcker Rule.

AUTHORIZED RISKS, INSTRUMENTS AND PRODUCTS: A banking entity must implement and enforce **limits and internal controls** for each trading desk that are reasonably designed to ensure that trading activity is conducted in compliance with the law and the entity's policies and procedures. Risk limits must be based on specified criteria.

HEDGING POLICIES AND PROCEDURES: A banking entity must establish, maintain and enforce **written policies and procedures** regarding the **use of risk-mitigating hedging instruments and strategies**.

ANALYSIS AND QUANTITATIVE MEASUREMENTS: A banking entity must perform **robust analysis and quantitative measurement** of trading activities reasonably designed to ensure that the trading activity of each trading desk is consistent with the entity's compliance program. This includes any quantitative metrics specifically tailored to the banking entity's particular risks, practices and strategies

OTHER COMPLIANCE MATTERS: Additional requirements apply to identify and monitor permitted trading activities, activities excluded from the definition of proprietary trading, high-risk assets and trading strategies and potential conflicts of interest.

REMEDATION OF VIOLATIONS: The compliance program must describe procedures for identifying violations of the Volcker Rule and **require prompt documentation and remediation** of any violation and document all proposed and actual remediation efforts. Written policies and procedures must provide for assessment of the extent to which program modifications are needed and implemented, as well as **prompt notification of material weaknesses or significant deficiencies** in program design or implementation to senior management and the board of directors.

INDEPENDENT TESTING

Independent testing of the compliance program, internal controls and management procedures **must occur** with a frequency appropriate to the size, scope and risk profile of the banking entity's trading and covered fund activities or investments, **at least annually**. Testing may be conducted by the banking entity's internal audit department, compliance personnel or risk managers outside the organizational unit tested, outside auditors/consultants, or other qualified independent parties.

TRAINING

A banking entity must provide **adequate training** to personnel and managers of the banking entity engaged in covered activities and to other appropriate supervisory, risk, independent testing, and audit personnel, to effectively implement and enforce the compliance program. This training should occur with a frequency appropriate to the size and the risk profile of the banking entity's trading activities.

RECORDKEEPING

A banking entity must create and retain **records sufficient to demonstrate compliance and support** the operations and effectiveness of the compliance program. A banking entity must retain these records for a period of **no fewer than 5 years** or such longer period as required by regulators in a form that allows it to promptly produce such records to regulators on request.

METRICS

<p>Risk Management</p>	<ul style="list-style-type: none"> ▪ Risk and Position Limits and Usage ▪ Risk Factor Sensitivities ▪ Value at Risk (VaR) and Stress Value at Risk (Stress VaR)
<p>Source of Revenue</p>	<ul style="list-style-type: none"> ▪ Comprehensive Profit and Loss Attribution
<p>Customer-Facing Activity</p>	<ul style="list-style-type: none"> ▪ Inventory Turnover ▪ Inventory Aging ▪ Customer-Facing Trade Ratio – Trade Count Based and Value Based

KEY PROCEDURES AND LOGISTICS

<p>Certain Reporting Remains Optional</p>	<ul style="list-style-type: none"> ▪ Reporting required: Metrics in respect of trading conducted pursuant to the underwriting-related, market making-related, risk-mitigating hedging and U.S./ foreign government obligation permitted activities ▪ Reporting optional: Metrics in respect of trading conducted pursuant to an exclusion from the scope of proprietary trading, or pursuant to the on behalf of customers, regulated insurance company or foreign bank permitted activities
<p>Level of Measurement</p>	<ul style="list-style-type: none"> ▪ Each trading desk, 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 of the banking entity. This may span across legal entities.
<p>Regulatory Reporting Frequency</p>	<ul style="list-style-type: none"> ▪ For banking entities with \$50 billion or more in trading assets and liabilities: for each calendar month, within 30 days of the end of the relevant month (beginning with information for January 2015, within 10 days of month end) ▪ For other banking entities: for each calendar quarter, within 30 days of quarter end
<p>Record Retention</p>	<ul style="list-style-type: none"> ▪ 5 years; records documenting preparation/content of reports submitted and information necessary to permit regulators to verify accuracy of reports

Timing and Applicability of Compliance and Metrics by Asset Size



STANDARD COMPLIANCE PROGRAM – NO METRICS

Banking entities with more than \$10 billion but less than \$50 billion of total consolidated assets and less than \$10 billion of trading assets and liabilities

Compliance required: July 21, 2015

Banking entities with \$10 billion or less in total assets or no Volcker Rule covered activity (other than permitted under the exemption for U.S. domestic government obligations) may have lighter compliance obligations.

ENHANCED COMPLIANCE PROGRAM – NO METRICS

Banking entities with \$50 billion or more of total consolidated assets but less than \$10 billion of trading assets and liabilities

Compliance required: July 21, 2015

ENHANCED COMPLIANCE PROGRAM WITH METRICS

Banking entities with total consolidated assets of \$50 billion or more.
Enhanced Program effective: July 21, 2015

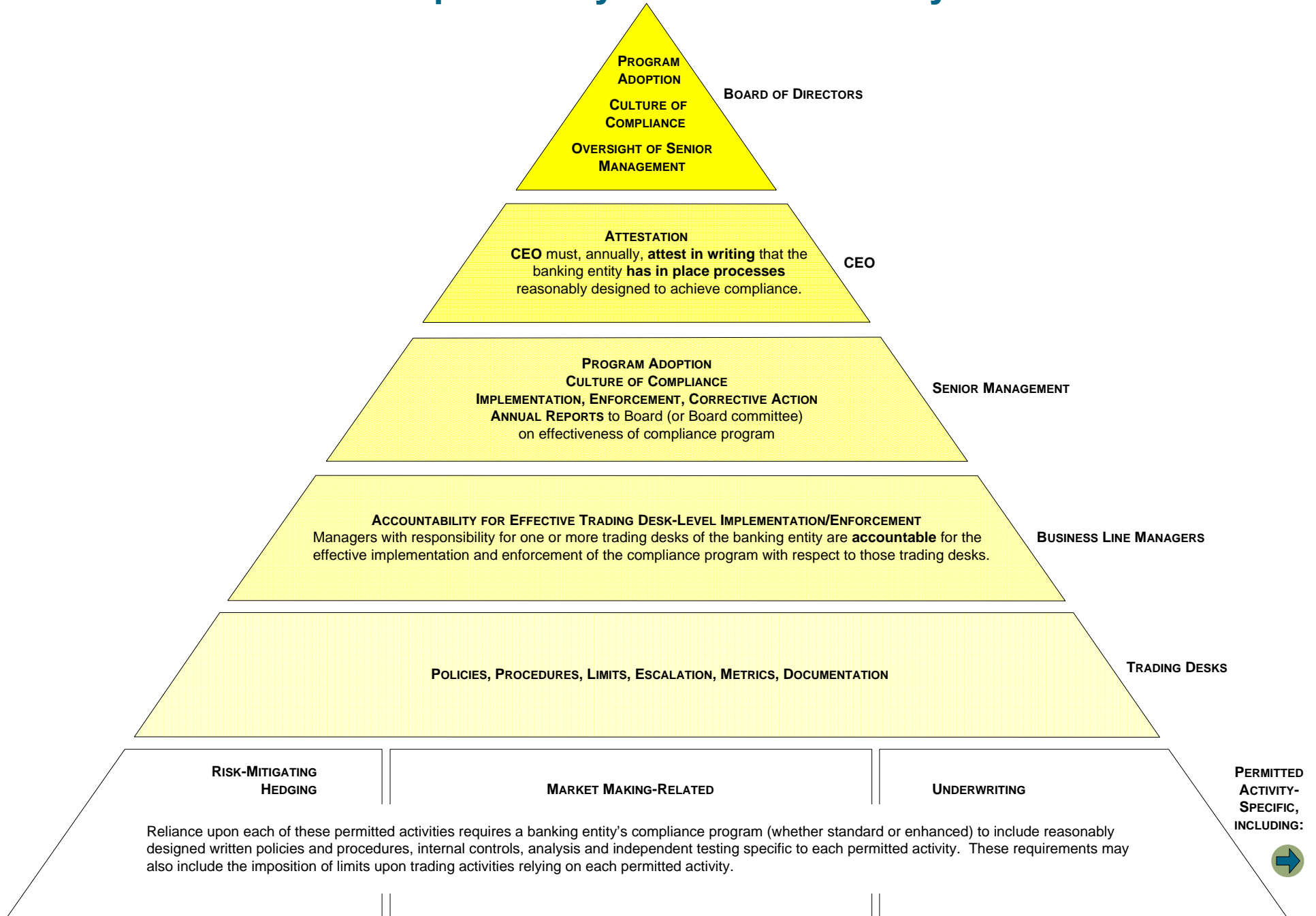
Phase-in for metrics reporting requirements for banking entities with \$10 billion or more in trading assets and liabilities:

- For those with trading assets and liabilities of \$50 billion or more:
Metrics: **June 30, 2014**
- For those with trading assets and liabilities of between \$25 billion and \$50 billion:
Metrics: **April 30, 2016**
- For those with trading assets and liabilities of between \$10 billion and \$25 billion:
Metrics: **December 31, 2016**

Trading Assets and Liabilities: The average gross sum of trading assets and liabilities that the banking entity has, together with its affiliates and subsidiaries, excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States, on a worldwide consolidated basis over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters.

A foreign banking entity is required to include only total consolidated assets and trading assets and liabilities of the combined U.S. operations of the foreign banking entity (including all subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the United States) over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters.

Enhanced Compliance Program Responsibility and Accountability



VOLCKER RULE FINAL REGULATIONS (RELEASED DECEMBER 10, 2013)



COMPLIANCE PROGRAMS (STANDARD OR ENHANCED) MUST ADDRESS ELEMENTS SPECIFIC TO A BANKING ENTITY'S MARKET MAKING-RELATED, UNDERWRITING AND RISK-MITIGATING HEDGING PERMITTED ACTIVITIES.

MARKET MAKING-RELATED

For its market making-related activities, a banking entity's compliance program must address:

The financial instruments the trading desk stands ready to purchase and sell.

Risk management elements:

- The **actions the trading desk will take** to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure (consistent with the limits set in the desk);
- the **products, instruments, and exposures** each trading desk may use for risk management purposes;
- the **techniques and strategies** each trading desk may use to manage the risks of the activities and inventory; and
- the **process, strategies, and personnel** responsible for ensuring that the actions taken to mitigate these risks **are and continue to be effective**.

Limits for the trading desk, based on the nature and amount of the trading desk's activities, that address:

- the **amount, types, and risks** of its market-maker inventory;
- the amount, types, and risks of the products, instruments, and exposures the trading desk may use for risk management purposes;
- the **level of exposures to relevant risk factors** arising from its financial exposure; and
- the **period of time** a financial instrument may be held.

Internal controls and ongoing monitoring and analysis of the trading desk's compliance with its limits.

Authorization procedures, including **escalation procedures that require review and approval** of any trade that would exceed the trading desk's limits, demonstrable analysis that the basis for any temporary or permanent increase to the trading desk's limits is consistent with the requirements of the exemption, and independent review of such demonstrable analysis and approval.

RISK-MITIGATING HEDGING

For its risk-mitigating hedging activities, a banking entity's compliance program must address:

Reasonably designed 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 with respect to such positions, contracts or other holdings.

Internal controls and ongoing monitoring, management, and authorization and escalation procedures.

The conduct of analysis, including correlation analysis, and independent testing of the policies and procedures.

RISK-MITIGATING HEDGING: ADDITIONAL DOCUMENTATION

For purchases or sales under the risk-mitigation hedging permitted activity that are:

- **Not established by the specific trading desk** establishing or responsible for the underlying positions being hedged;
- Established by the same trading desk responsible for the underlying positions, **but effected** through a financial instrument, exposure, technique, or strategy that is **not specifically identified in the trading desk's written policies and procedures**; or
- Established to hedge aggregated positions **across two or more trading desks**.

Contemporaneously, the banking entity must document, at a minimum:

- The specific, identifiable risks of the identified positions, contracts, or other holdings of the banking entity that the hedging transaction is designed to reduce;
- The specific risk-mitigating strategy that the purchase or sale is designed to fulfill; and
- The trading desk or other business unit that is establishing and responsible for the hedge.

UNDERWRITING

For its underwriting activities, a banking entity's compliance program must address:

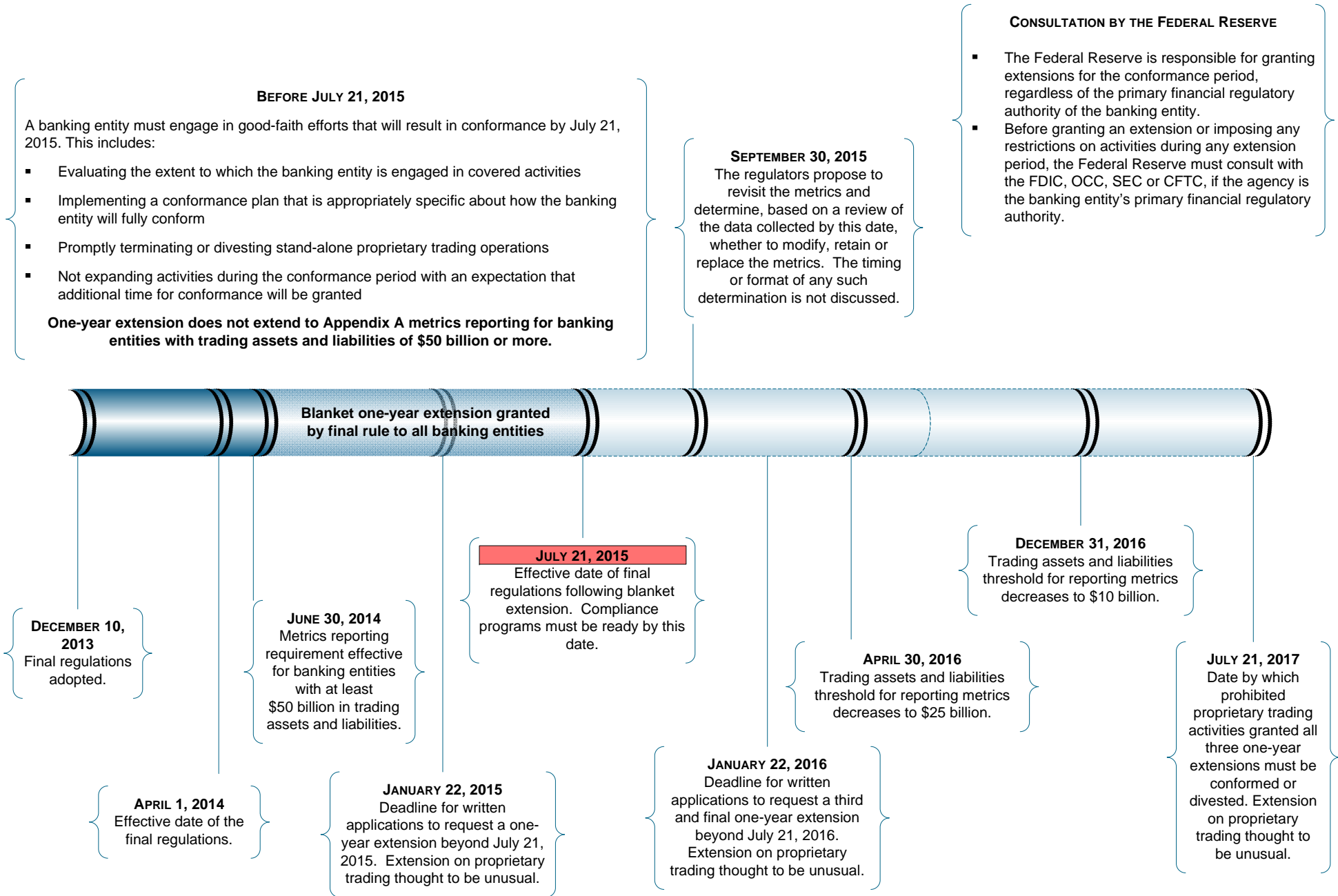
The products, instruments or exposures each trading desk may purchase, sell, or manage as part of its underwriting activities.

Limits for each trading desk, based on the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers, or counterparties, on the:

- **Amount, types, and risk of its underwriting position**;
- Level of exposures to relevant risk factors arising from its underwriting position; and
- **Period of time** a security may be held.

Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits.

Authorization procedures, including **escalation procedures that require review and approval** of any trade that would exceed a trading desk's limits, demonstrable analysis of the basis for any temporary or permanent increase to a trading desk's limits, and independent review of such demonstrable analysis and approval.



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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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