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Client Alert

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The Volcker Rule Prohibition on Proprietary Trading: Considerations for Broker-Dealer Affiliates of Foreign Banking Organizations

The Volcker Rule imposes significant restrictions on "proprietary trading" by banking organizations and their affiliates. The purpose of this Memorandum is to discuss how these restrictions may impact broker-dealer affiliates of foreign banking organizations that conduct business in the United States or with U.S. customers. For an overview of the Volcker Rule, see *A User's Guide to the Volcker Rule*, available at http://www.mofo.com/files/Uploads/Images/131223-A-Users-Guide-to-The-Volcker-Rule.pdf, and for a discussion of the general impact of the Volcker Rule on foreign banking organizations, see *The Volcker Rule: Impact of the Final Rule on Foreign Banking Organizations*, available at http://www.mofo.com/files/Uploads/Images/131211-Volcker-Rule.pdf.

Overview of the Restrictions on Proprietary Trading

The Volcker Rule applies to all banking entities, which are defined to include foreign banking organizations that have U.S. branches or agencies or which own U.S. banks or certain other U.S. subsidiaries ("FBOs"). Also covered by the Rule are affiliates of FBOs, including affiliated broker-dealers located in the United States or overseas.

The Rule sets forth a general prohibition on "proprietary trading", which is defined as engaging as principal in the purchase or sale of financial instruments for a trading account of a banking entity. "Proprietary trading" does not include transactions undertaken on an agency basis.[1] "Financial instruments" include securities, derivatives and commodity futures contracts.[2] Loans and foreign exchange are not included within the definition. "Trading account" is defined to cover transactions effected by a securities dealer affiliated with a banking entity or transactions by a bank or any affiliate if the purpose is to trade for short-term gain or for hedging or arbitrage purposes. Financial instruments held for less than 60 days are presumed to be held for short-term trading purposes.

Thus, but for the exemptions discussed below, the Volcker Rule would largely limit broker-dealers affiliated with FBOs to acting as agents for their customers.

Exemption for Transactions Conducted Solely Outside the United States

The Volcker Rule exempts FBOs and their affiliates from the restrictions on proprietary trading for transactions that are conducted solely outside the United States (the "SOTUS Exemption"). The SOTUS Exemption is available to FBOs and their affiliates subject to the following conditions:

[1] In addition, riskless principal trades and trades undertaken in a fiduciary capacity are exempted from the general prohibition on proprietary trading.

[2] This Memorandum only addresses issues for securities broker-dealers. Similar requirements would apply to swap dealers and futures commission merchants affiliated with FBOs.

- The FBO conducts a majority of its business outside the U.S. and is not controlled by a U.S. banking entity (i.e., the FBO is a Qualifying Foreign Banking Organization, or QFBO);
- The FBO or its affiliate engaged in the trading is located outside the U.S.;
- Trading decisions are made by personnel located outside the U.S.;
- The trades are booked outside the U.S.;
- No financing for the trading is provided by any U.S. affiliate or branch of the FBO;
- Trades are not conducted with or through any U.S. entity except:
    - Trades through an unaffiliated U.S. intermediary acting as principal provided the trades are promptly settled through a clearing agency;
    - Trades through an unaffiliated U.S. intermediary acting as agent if the trade is effected anonymously on an exchange or similar facility and the trade is promptly settled through a clearing agency; or
    - Trades with foreign operations of U.S. entities.

Foreign broker-dealers affiliated with FBOs will presumably rely upon the SOTUS Exemption to conduct their trading on a principal basis outside the United States. However, established practices for trading on a principal basis with U.S. customers may need to be revised in order to conform to the Volcker Rule. The SOTUS Exemption is only available for trades effected on a principal basis with U.S. customers or counterparties if such trades are effected through an *unaffiliated* U.S. intermediary.[3] The Volcker Rule thus prohibits FBOs and their affiliates from effecting such proprietary trades through their affiliated broker-dealers located in the United States.

The implications of this restriction should be considered in light of the practices developed by FBOs and their U.S. broker-dealer affiliates under SEC Rule 15a-6. That rule was adopted in 1989 in large part to facilitate access by U.S. institutional investors to foreign securities. Under Rule 15a-6, foreign broker-dealers and banks acting in a principal or agency capacity may solicit transactions with U.S. institutional investors, provided that such transactions are effected through a U.S. registered broker-dealer. Many FBOs have established U.S. registered broker-dealers that, among other things, facilitate trading between the FBO and its offshore broker-dealers on the one hand and U.S. institutional investors on the other hand. While such trading practices may continue for trades effected on an agency basis, the Volcker Rule prohibits FBOs from effecting such trades on a principal basis through their affiliated U.S. broker-dealers. This could reduce the business of such affiliated broker-dealers and complicate the ability of U.S. institutional investors to trade in foreign securities, contrary to the rationale of SEC Rule 15a-6.

Participation in Securities Distributions

Dealers often participate as principals in the distribution of securities. For example, in a firm commitment underwriting or a traditional Rule 144A transaction, securities dealers acquire newly issued securities from the issuer for the purpose of promptly reselling them to their customers. Under the Volcker Rule, purchasing securities as principal for the purpose of prompt resale would be deemed proprietary trading and would be prohibited unless the transactions come within the scope of the SOTUS Exemption or the exemption for underwriting activities.

[3] In addition, the SOTUS Exemption permits FBOs to trade on a principal basis with foreign branches and offices of U.S. entities.

The Rule includes an underwriting exemption for participation in "distributions" in which a properly licensed affiliate of the banking entity is acting as an "underwriter". Compliance with the underwriting exemption would permit FBO-affiliated broker-dealers to participate in public and private offerings of securities in the United States. "Underwriter" is broadly defined to include selling group members and distributors. "Distribution" is defined as:

- An offering registered with the SEC under the Securities Act of 1933, or
- Any other offering that is "distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods…."

There is no definition of special selling efforts or selling methods, although in a Preamble issued by the federal agencies which adopted the Rule there is a discussion which provides some illustrative examples, such as roadshow presentations.

If a banking entity avails itself of the underwriting exemption, it must comply with a wide range of additional requirements. For example, the banking entity's position in the securities which are the subject of the distribution must not exceed "the reasonably expected near term demands of clients, customers, or counterparties…." Forecasting "near term demands" must be based on its experience with similar offerings, its knowledge of market conditions and similar inputs. In addition, compensation for persons engaged in the underwriting must be designed not to incentivize prohibited proprietary trading. Moreover, the banking entity must implement and maintain additional internal compliance standards detailed in Subpart D of the Volcker Rule ("Subpart D Compliance Program") and is subject to various additional reporting obligations. See the discussion below as well as *The Volcker Rule and Capital Markets Offerings*, available at http://www.mofo.com/files/Uploads/Images/131227-Volcker-Rule-Capital-Markets-Offerings.pdf, for a more detailed discussion of this topic.

As noted above, the prohibition on proprietary trading does not apply when an FBO-affiliated broker-dealer acts in an agency capacity. Considering the additional compliance burdens required to participate as a principal in securities distributions in the United States, it is possible that some bank-affiliated broker-dealers will seek to restructure their role in distributions in order to avoid the application of the Volcker Rule. For example, in a traditional 144A transaction, one or more dealers acquire securities from the issuer for resale to Qualified Institutional Buyers ("QIBs"). Consideration might be given to restructuring such transactions so that the issuer will sell directly to the QIBs in a private placement, with the broker-dealer acting as a placement agent ("144A Qualifying Deals"). The issued securities could have a CUSIP number and settlement could be arranged through DTC/Euroclear in order to facilitate liquidity within the constraints of 144A.

FBOs and their offshore broker-dealers should be able to continue to act as underwriters for the international tranche of global offerings in reliance upon the SOTUS Exemption. The fact that the global offering includes a 144A tranche sold into the U.S. should not prevent reliance on the SOTUS Exemption. However, FBOs acting as underwriters in the international tranche should not participate in the 144A tranche and any participation in the U.S. tranche by their U.S. affiliated broker-dealers must be structured as agency transactions or in a manner to conform to the underwriting exemption.

Market Making

The Volcker Rule also includes a market making exemption from the prohibition on proprietary trading. Such exemption is essential for any market making activities that are not covered by the SOTUS Exemption, given the fact that market making is inherently a series of transactions conducted on a principal basis. In order to utilize this exemption, the broker-dealer must:

- Stand ready to purchase/sell/quote the securities in which a market is being made;
- Maintain an inventory which is designed not to exceed reasonably expected near term demands of clients, customers and counterparties;
- Implement and maintain additional standards in its Subpart D Compliance Program, including trading limits, policies and internal controls designed to manage risk; and
- Utilize compensation arrangements for personnel engaged in market making designed not to incentivize impermissible proprietary trading.

The "near term demands" for the securities held in inventory must be determined based on an analysis of the market and a "demonstrable analysis of historical customer demand…." In calculating near term demand, it should also be noted that "clients, customers and counterparties" do not include other banking entities with trading assets and liabilities in excess of $50 billion, unless the broker-dealer can demonstrate why the banking entity should be treated as a customer. However, inter-dealer trading with banking entities of all sizes would be permitted to the extent such trading is undertaken to support the broker-dealer's market making activities.

Thus, while FBO-affiliated broker-dealers may continue to engage in market making, unless such market making is conducted entirely outside the United States they will need to undertake a rigorous analysis of their inventory needs and they will need to comply with the additional requirements and reporting obligations set forth in the Subpart D Compliance Program.

Other Permitted Proprietary Trading

The Rule permits proprietary trading by FBO-affiliated broker-dealers in:

- U.S. Treasury and agency securities;
- Municipal securities; and
- Sovereign securities issued or guaranteed by the government of the country in which the FBO is organized.[4]

The Rule also permits FBO-affiliated broker-dealers to engage in riskless principal transactions and in principal transactions conducted on a fiduciary basis.

Trading on an Agency Basis

The Volcker Rule only limits proprietary trading. FBOs and their affiliates may continue to trade on an agency basis in the same manner as they have in the past. Such activities could include:

- Acting as a broker to fill customer orders to buy or sell securities;
- Trading on an agency basis with U.S. institutional investors, utilizing their U.S. affiliated broker-dealers to effect the trade under Rule 15a-6;

[4] Under the SOTUS Exemption, FBOs are free to trade on a principal basis in any sovereign securities, provided that the transactions are effected and booked solely outside the U.S.

- Furnishing research reports to U.S. institutional investors in accordance with the requirements of Rule 15a-6;
- Effecting agency cross trades;
- Acting as a placement agent in private placements;
- Acting on an agency basis in 144A Qualifying Deals as discussed above;
- Facilitating registered direct offerings; and
- Acting as an adviser on M&A transactions.

Material Conflicts of Interest; Avoidance of High Risk

All proprietary trading permitted under the Volcker Rule is subject to three general prohibitions, sometimes referred to as prudential backstops: (i) the trading may not involve a material conflict of interest with a client, customer or counterparty; (ii) the trading does not expose the banking entity to a high-risk asset or trading strategy; and (iii) the trading must not pose a threat to the safety and soundness of the banking entity or the financial stability of the United States. Material conflicts with customers may be effectively addressed through clear and timely disclosures made prior to the transaction. Alternatively, the banking entity may rely on information barriers to resolve the conflict, although such reliance is not permitted if, notwithstanding the barrier, the conflict of interest might result in a materially adverse effect on the customer. Although the prudential backstops apply to trading under the SOTUS Exemption, it is not clear how U.S. authorities would enforce such provisions with respect to trading which takes place entirely outside the United States.

Recordkeeping and Reporting Obligations

FBOs with substantial U.S. trading assets and liabilities will be subject to certain recordkeeping and reporting obligations. The obligations are applicable if the combined trading assets and liabilities of all the FBO's U.S. operations exceed the thresholds set forth below. Once subject to the requirements, the FBO will be required to calculate on a daily basis various metrics relating to their proprietary trading activity. In addition, reports must be filed on a quarterly basis (monthly basis for FBOs with more than $50 billion in U.S. trading assets and liabilities) with the applicable U.S. regulatory agencies. Proprietary trading undertaken pursuant to the SOTUS Exemption does not need to be included in such calculations or reports. However, all other proprietary trading by the FBOs is covered. The specific recordkeeping and reporting requirements are set forth in Appendix A to the Volcker Rule. The reporting obligation commences on June 30, 2014 for FBOs with at least $50 billion in U.S. trading assets or liabilities; on April 30, 2016 for FBOs with at least $25 billion in U.S. trading assets and liabilities; and on December 31, 2016 for FBOs with at least $10 billion in U.S. trading assets and liabilities. FBO-affiliated broker-dealers that engage in proprietary trading will need to establish internal reporting protocols to ensure that any required information is made available on a timely basis to their affiliated FBO.

Subpart D Compliance Program

The Volcker Rule requires all banking entities to develop a compliance program reasonably designed to ensure and monitor compliance with the restrictions on proprietary trading. The minimal elements of such program, which will appear familiar to most broker-dealer compliance officers, must include:

- Written policies and procedures designed to monitor and limit covered trading activity;
- Internal controls to monitor compliance;

- A management framework which delineates responsibility for compliance;
- Independent testing and auditing of the effectiveness of the compliance program;
- Training of trading personnel and managers; and
- Recordkeeping to demonstrate compliance.

Additional compliance standards are required of FBOs that engage in proprietary trading and have at least $50 billion in U.S. assets or which engage in market making and securities distributions. The additional compliance standards require additional policies and procedures intended to monitor and limit the risk from proprietary trading. For example, FBOs subject to such additional standards will be required to implement policies and procedures that specify for each trading desk the applicable mission, authorized activities, trading limits and types of customers and counterparties with whom the desk may trade. The additional standards are set forth in Appendix B to the Volcker Rule.

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