June 8, 2018

Federal Agencies Propose Amendments to Volcker Rule

On June 5, the SEC, following approval by the Federal Reserve, the Department of the Treasury, the FDIC and the CFTC, approved a notice of proposed rulemaking by a vote of 3-2 that attempts to simplify and more narrowly tailor the "Volcker Rule," one of the key elements of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

The Volcker Rule (Section 13 of the Bank Holding Company Act of 1956) prohibits insured depository institutions and certain other banking entities from engaging in proprietary trading or acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with hedge funds and private-equity funds ("covered funds"). The limitations set forth in the Volcker Rule incorporate a number of definitions and provide for a variety of exceptions that many market participants have argued need to be clarified and streamlined. While the proposed rules attempt to simplify compliance burdens under the Volcker Rule, in particular for small and mid-size firms that do not have large trading operations, they do not undo its fundamental structure.

The proposed rules follow the 2017 report on financial reform by the U.S. Department of the Treasury (see our client alert here), which highlighted concerns that the Volcker Rule regulations are overly complex and should be tailored to reduce compliance costs, and the recently enacted Economic Growth, Regulatory Relief, and Consumer Protection Act (see our client alert here), which limits the application of various provisions of Dodd-Frank to small and mid-size banks and raises asset thresholds above which larger banks are subject to increased oversight and regulation.

In the proposed rules, the SEC and the other agencies charged with developing and adopting regulations to implement the Volcker Rule acknowledge concerns that some provisions of the rules implementing the Volcker Rule may be unclear and potentially difficult to comply with in practice. Based on the agencies' experience with the Volcker Rule since its adoption, the proposed rules are intended to address these concerns and provide banking entities with greater clarity and certainty about which activities are permitted and which are prohibited.

Among other things, the proposed rules:

- tailor the Volcker Rule's compliance requirements based on the size of a firm's trading assets and liabilities, with the most onerous requirements applying to firms with the most trading activity and reduced compliance and recordkeeping requirements for firms with moderate or limited trading assets and liabilities;

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- revise the definition of "trading account";
- clarify that firms that trade within appropriately developed internal risk limits are engaged in permissible market-making or underwriting activity, and streamline the criteria that apply when a banking entity seeks to rely on the hedging and foreign bank exemptions; and
- simplify metrics reporting requirements.

In addition, the agencies requested comment on the definition of, and permitted relationships with, a "covered fund."

A summary of certain key provisions of the proposed rules is set forth below.

Tailored Requirements for Different Sized Banking Entities

The proposed rules would establish three categories of banking entities based on the entity's trading assets and liabilities and would tailor compliance requirements for each category.

- ***Banking entities with significant trading assets and liabilities***. Banking entities that, together with their affiliates and subsidiaries, have consolidated gross trading assets and liabilities (excluding obligations of or guaranteed by the United States or any agency of the United States) equal to or exceeding $10 billion would be required to maintain a "six-pillar" compliance program addressing written policies and procedures, internal controls, management framework, independent testing, training and records requirements commensurate with the size, scope and complexity of their activities and business structure, that banking entities could integrate into their existing compliance structures. A CEO (or equivalent officer) certification regarding the compliance program would also be required.
- ***Banking entities with moderate trading assets and liabilities***. Banking entities that, together with their affiliates and subsidiaries, have consolidated gross trading assets and liabilities (excluding obligations of or guaranteed by the United States or any agency of the United States) less than $10 billion but equal to or above $1 billion would be subject to simplified compliance requirements, although the CEO (or equivalent officer) attestation requirement would apply.
- ***Banking entities with limited trading assets and liabilities***. Banking entities that have, together with their affiliates and subsidiaries, consolidated gross trading assets and liabilities (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) less than $1 billion would enjoy a rebuttable presumption of compliance with the Volcker Rule and would not be required to establish a compliance program unless requested by the relevant regulator. For a foreign banking organization ("FBO") and its

subsidiaries, the $1 billion threshold would be based on worldwide consolidated trading assets and liabilities, and would not be limited to its combined U.S. operations. According to the proposed rules, all but approximately 40 top-tier banking entities would be eligible for presumed compliance under this provision.

A regulator could require a banking entity with limited or moderate trading assets and liabilities to apply any of the more extensive requirements that otherwise would apply if the entity had significant or moderate trading assets or liabilities, if the regulator determines that the size or complexity of the entity's trading or investment activities, or the risk of evasion, warrants such treatment.

Revised Definition of Trading Account

The Volcker Rule's proprietary trading prohibitions apply to positions taken as principal for the trading account of a banking entity. The Volcker Rule defined trading account as having three prongs:

- the "short-term intent prong" (an account to purchase or sell one or more financial instruments principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position);

- the "market risk capital prong" (trading positions that are both covered positions and trading positions for purposes of the Federal banking agencies' market risk capital rules, as well as hedges of covered positions); and

- the "dealer prong" (an account used by a banking entity that is a securities dealer, swap dealer, or security-based swap dealer that is licensed or registered, or required to be licensed or registered, as a dealer, swap dealer, or security-based swap dealer, to the extent the instrument is purchased or sold in connection with the activities that require the banking entity to be licensed or registered as such).

The agencies noted that determining whether or not positions fall into the short-term intent prong of the trading account definition has often proven to be unclear and subjective. The proposed rules would replace this prong with a prong based on the accounting treatment of a position (the "accounting prong"), while retaining the market risk capital prong and the dealer prong. The accounting prong would provide that the Volcker Rule trading account includes any account used by a banking entity to purchase or sell one or more financial instruments that is recorded at fair value on a recurring basis under applicable accounting standards, and would generally cover derivatives, trading securities and available-for-sale securities. The market risk capital prong and the dealer prong of the trading account definition would be subject to limited adjustment, but otherwise would generally remain unchanged.

Significantly, the proposed rules would also eliminate the rebuttable presumption that any security held for less than 60 days is a proprietary trade, and would introduce a presumption that trading desks not

subject to the market risk capital prong or the dealer prong that fall within a $25 million profit and loss threshold (on a rolling 90-day look-back basis) are not in violation of the Volcker Rule. The proposed rules also modify the exclusion for liquidity management and adopt new exclusions for transactions made to correct errors and for certain offsetting swap transactions.

Underwriting, Market-Making, Hedging and Foreign Bank Exemptions

Under the Volcker Rule, transactions in connection with underwriting and market-making activities, to the extent designed not to exceed reasonably expected near-term demand of clients, customers, or counterparties ("RENTD"), are exempt from the prohibition on proprietary trading. The proposed rules would provide that the purchase or sale of a financial instrument by a banking entity (both with and without significant trading assets and liabilities) is presumed to fall within this exemption if the banking entity establishes underwriting and market-making internal risk limits for each trading desk and implements, maintains and enforces those limits. A banking entity would not be required to adhere to any specific, pre-defined requirements for the limit-setting process.

In addition, the proposed rules would:

- reduce certain hedging limitations for all banking entities, and remove most hedging limitations for banking entities with moderate or limited trading assets and liabilities;
- permit a banking entity to acquire or retain an ownership interest in a covered fund as a risk-mitigating hedge when acting as an intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund; and
- eliminate the correlation analysis requirement from the hedging exemption, as well as the requirement that the hedging transaction "demonstrably reduce" or otherwise "significantly mitigate" a specific risk.

For firms with moderate or limited trading assets and liabilities, compliance, documentation and other requirements of the hedging exemption under the Volcker Rule are further simplified as long as the hedge is designed at the inception of the hedging activity to reduce or otherwise significantly mitigate an identifiable risk and it is subject to ongoing recalibration. Although entities with significant trading assets and liabilities would continue to be subject to enhanced documentation requirements for certain hedging activities, these enhanced requirements would not apply if they are identified as hedging transactions that are commonly used by the trading desk and subject to pre-approved limits.

The proposed rules also modify or remove several conditions from the "trading outside the United States" or TOTUS exemption and would permit a foreign banking entity to engage in a purchase or sale under the

exemption so long as the "principal risk and actions of the purchase or sale" do not take place in the United States.

Simplified Metrics Reporting Requirements

The proposed rules would streamline the metrics reporting and recordkeeping requirements by tailoring the requirements based on a banking entity's size and level of trading activity, eliminate particular metrics and add a limited set of new metrics. Taken together, these changes – particularly limiting the applicability of certain metrics requirements only to trading desks engaged in certain types of covered trading activity – are designed to reduce compliance-related inefficiencies created by the Volcker Rule. Additional time would also be provided for certain firms to report their metrics.

Potential Revision to Definition of "Covered Fund"

The Volcker Rule defines covered fund to include issuers of the type that would be investment companies but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, such as hedge funds and private equity funds. Without proposing specific changes to the definition of covered fund, the agencies requested comment on whether the definition is inappropriately imprecise and should be further tailored to:

- modify the conditions of various exclusions from the covered fund definition, including those for foreign public funds, family wealth management vehicles, joint ventures, securitizations and other issuers;
- define "covered fund" with reference to certain fund characteristics, and exclude from the definition of "covered fund" entities that lack certain characteristics commonly associated with being a hedge fund or a private equity fund; or
- reference an existing definition, such as the Form PF definitions of "hedge fund" and "private equity fund."

The agencies also requested comment on whether the exemptions provided in Section 23A of the Federal Reserve Act, which would allow banking entities to extend credit to certain covered funds with which they are associated, should be incorporated into the Volcker Rule and would remove as a condition of the foreign fund exemption to the Volcker Rule the requirement that no financing for the banking entity's ownership or sponsorship of covered fund interests be provided by any branch or affiliate that is located in or organized under the laws of the United States.

The comment period will be open for 60 days after publication of notice in the Federal Register.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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