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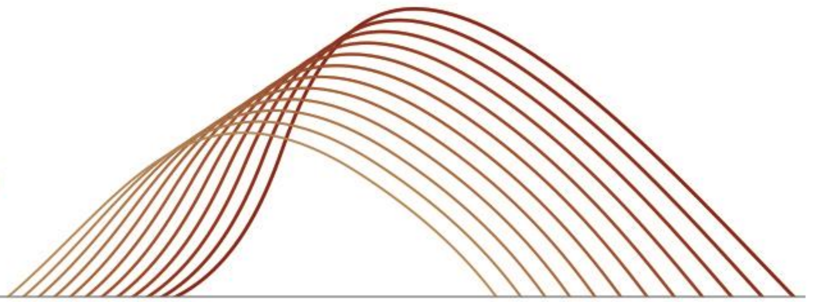

June 2018

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Tinker, Tailor, Volcker Simplify: Bank Regulators Propose Revisions to the Volcker Rule

By Lawrence D. Kaplan & Joshua S. Downer

Federal bank regulators recently have proposed revisions to the so-called Volcker Rule, which restricts banking entities from proprietary trading and acquiring interests in covered funds (the "Proposed Revision") as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] The Proposed Revision, developed collectively among the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodities Future Trading Commission (the "Federal banking agencies" or "Agencies"), would alter aspects of the final rule adopted in December 2013 (the "2013 Rule"), by tailoring the regulatory framework based on amount of trading activity and simplifying compliance requirements for all banking entities. These changes seek to modify the Volcker Rule from a strict, prescriptive form of regulation to a principles-oriented form of regulation, permitting banking entities to trade within risk-based ranges rather than compelling compliance with bright-line tests.

The Federal banking agencies also are seeking public comment on other aspects of the rule, including whether to create additional exemptions to the definition of a covered fund and to prohibitions on transactions between banking entities and affiliated covered funds based on exemptions contained in Regulation W.[2] Comments on the Proposed Revision will be due in early August, 60 days following publication in the *Federal Register*.

I. Tiered Compliance Framework Based on Amount of Trading Activity

The Proposed Revision would create three categories of regulated entities based on an entity's consolidated gross trading assets and liabilities ("Trading Activity") and establish corresponding requirements:

1. Banking entities with "**significant**" Trading Activity, meaning at least $10 billion, would no longer be subject to enhanced minimum standards, but would be required to maintain:

   – the "six-pillar" compliance program, including written policies and procedures, internal controls, a management framework, independent testing and audit, training for relevant personnel and recordkeeping requirements;

   – the metrics reporting requirements;

   – the underwriting and market-making program requirements;

– the covered fund documentation requirements; and

– the CEO attestation requirement;

2. Banking entities with "**moderate**" Trading Activity, meaning between $1 and 10 billion:

   – would be permitted to establish a simplified compliance program;

   – must continue to comply with the CEO attestation requirement; and

3. Banking entities with "**limited**" Trading Activity, meaning less than $1 billion, would:

   – be presumed to be compliant with the Volcker Rule; and

   – not be required to create a special Volcker Rule compliance program unless specifically required by the Federal Bank Regulators.

The chart at the end of this Stay Current summarizes the proposed changes to compliance program requirements.

The Proposed Revision follows up on banking legislation enacted in May 2018 (the "Relief Bill") that exempts from the Volcker Rule any banking entity that has (i) less than $10 billion in total consolidated assets and (ii) total trading assets and trading liabilities representing less than 5% of its total consolidated assets.[3] Although the Proposed Revision does not purport to implement any aspect of the Relief Bill, the Agencies have stated that they will not enforce the 2013 Rule in a manner inconsistent with those exemptions.

II. A More Lenient Approach to Restrictions on Proprietary Trading

A. Shifting Presumptions and Expanding Exemptions

In defining "trading account," which impacts application of the Volcker Rule's proprietary trading restrictions, the Proposed Revision replaces a bright-line subjective test that presumed a banking entity was engaged in proprietary trading with an objective standard, establishing a favorable presumption for banking entities whose Trading Activities falls within certain limits.

Specifically, the Federal banking agencies note that, by statute, the Volcker Rule's proprietary trading restrictions apply to a banking entity that takes positions or engages as principal for its own "trading account."[4] The statute further defines "trading account" to mean any account used for acquiring or taking positions in financial instruments principally for the purpose of selling "in the near term", or otherwise with the "intent to resell in order to profit from short-term price movements."[5]

The 2013 Rule imposed a three-pronged test for defining a trading account:

1. The "short-term intent" prong;

2. The "market risk capital" prong; and

3. The "dealer" prong.

Under the 2013 Rule, the "short-term intent" prong is problematic as it sets forth a rebuttable presumption that an account is a trading account if the banking entity holds the financial instrument in question for fewer than 60 days or substantially transfers the risk of the position within 60 days.

The Proposed Revision replaces the "short-term intent" prong—including eliminating the 60-day rebuttable presumption—with an objective standard based on the accounting treatment of a position (a new "accounting prong"). The accounting prong brings under the ambit of a Volcker Rule trading account any account used by a banking entity to buy or sell financial instruments that are recorded at fair value on a recurring basis under applicable accounting standards, such as derivatives, trading securities and available-for-sale securities.

The Proposed Revision maintains the "market risk capital" and "dealer" prongs, and adds a rebuttable presumption of compliance with the prohibition on proprietary trading for trading desks that are subject only to the accounting prong, subject to specified profit and loss limits. Accordingly, although banking entities subject to the accounting prong would still be prohibited from engaging in proprietary trading, those that remain within the specified threshold would not be required to demonstrate compliance on an ongoing basis.

Proprietary trading requirements would be further changed by the Proposed Revision by:

- expanding the liquidity management exclusion to the definition of proprietary trading to allow for the purchase and sale of foreign exchange forwards, foreign exchange swaps and physically-settled cross-currency swaps entered into for liquidity management purposes; and

- adding an "error trades" exclusion, which permits a banking entity to engage in transactions as principal to correct an erroneous purchase or sale of a financial instrument in the course of conducting a permitted or excluded activity.

These additional exemptions are notable in that they go beyond nominal tailoring changes, and instead permit a wider range of trading activity intended to improve the efficacy of trading desks in managing risk.

B. Market Making: From Proscribed Rules to Trust and Verify

As provided by the Dodd-Frank Act, the Volcker Rule exempts from the prohibition on proprietary trading a banking entities' underwriting and market-making activities, insofar as those activities do not exceed reasonably expected near term demand of clients ("RENTD"). To utilize this exemption, however, the Volcker Rule imposes onerous burdens to demonstrate compliance with RENTD, resulting in significant costs.

The Proposed Revision would replace the current conditions for meeting the market-making and underwriting exemptions with a streamlined approach by, most significantly, establishing that purchases and sales of financial entities will be presumed not to exceed RENTD if the banking entity complies with internally-created risk limits, subject to certain conditions. Additionally, banking entities with moderate and limited trading activity would not be required to have a specific compliance program in order to rely on these exemptions.

This proposed shift is significant. From the adoption of the Volcker Rule as part of the Dodd-Frank Act, the underwriting and market-making exemptions were widely considered to be the most critical in ensuring that banking entities' roles in the securities markets are not prohibited or unduly restricted.

By proposing to establish a presumption of compliance with RENTD based on internal procedures, the practical impediments to using these exemptions may be alleviated.

C. Expanding the Hedging Exemption

Under the Volcker Rule, restrictions on proprietary trading do not apply to risk-mitigating hedging activities that are designed to reduce specific risks with respect to trades or positions, subject to certain restrictions. To use this exemption, the 2013 Rule included a "correlation analysis" requirement and the requirement that a banking entity show that a risk-mitigating hedging activity demonstrably reduces or otherwise significantly mitigates specific risk. The Proposed Revision would eliminate these requirements. Additionally the Proposed Revision would eliminate enhanced documentation requirements for "common hedging" activity for all banking entities, subject to certain conditions.

Further, for banking entities with moderate or limited trading activities, the Proposed Revision would eliminate:

- the requirement for a separate hedging compliance program;
- limits on compensation arrangements for persons performing risk-mitigation hedging; and
- certain documentation requirements.

With those requirements eliminated, to use the hedging exemption under the Proposed Revision, banking entities with moderate or limited trading activities would be required to ensure that risk-mitigation hedging activity:

- be designed to mitigate specific, identifiable risks at the inception of the activity;
- be subject to ongoing calibration to make certain that a particular hedge continues to reduce or significantly mitigate the identifiable risk or risks.

D. Expanding the Foreign Proprietary Trading Exemption

The Proposed Revision would also loosen the requirements on what qualifies for the foreign trading exemption, placing focus on whether the banking entity conducting the trade (and relevant personnel) is located in the U.S., without making other limited activity that occurs in the U.S. disqualifying. Based upon feedback from foreign banking entities to 2013 Rule, the Proposed Revision remediates restrictions on certain foreign trading activity that the Agencies noted the Volcker Rule was not intended to cover.

Specifically, the Proposed Revision would eliminate the requirements that (i) any personnel of the banking entity that arranges, negotiates, or executes a purchase or sale not be located in the U.S., (ii) that no financing for the purchase or sale is provided by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or a U.S. state ("located or organized in the U.S."), and (iii) that the purchase or sale, generally, is not conducted through a U.S. entity.

Under the Proposed Revision, a foreign banking entity is exempt from proprietary trading restrictions if (i) the banking entity engaging as principal (including relevant personnel) is not located or organized in the U.S., (ii) the banking entity that makes the decision (including relevant personnel) is not

located or organized in the U.S., and (iii) the trade, including related hedging activity, is not accounted for as principal directly by any branch or affiliate that is located or organized in the U.S.

III. Seeking a More Lenient Approach to Covered Fund Restrictions

A. Interest in Excluding Additional Types of Funds

The Proposed Revision seeks comment on whether the definition of a "covered fund" should exclude additional types of funds, in addition to those listed in sections (3)(c)(1) and 3(c)(7) of the Investment Company Act ("ICA")[6] and the other specific exclusions provided for by the 2013 Rule. Opening to consideration the addition to the Volcker Rule's exemptions other exemptions in the ICA could expand further the universe of permissible investments, and is a potentially fruitful subject for comment to the Agencies.

B. Harmonizing Expansion of Underwriting and Market-Making Exemptions for a Covered Fund

The 2013 Rule provides that ownership of covered funds permitted under the underwriting or market-making exemptions are nevertheless subject to the requirement that the banking entity include in its aggregate fund limit and capital deduction the value of any ownership interests acquired in covered funds under those exemptions.

The Proposed Revision removes this requirement for a covered fund that a banking entity does not offer, in order to bring this exemption in alignment with the related exemptions for proprietary trading activity. However, the Proposed Revision would retain requirements related to the per-fund limit, aggregate fund limit and capital deduction for a covered fund that the banking entity organizes and offers. Further, the Proposed Revision would preserve requirements that a covered fund's underwriting or market-making activities be conducted in accordance with the underwriting and market-making exclusions.

C. Expansion of Risk-Mitigating Hedging Activities for Covered Funds

The Proposed Revision expands permitted risk-mitigating hedging activities involving ownership of covered funds, allowing a banking entity to acquire interest in a covered fund as a hedge when acting as an intermediary to a non-banking entity in order to expose the latter entity to profits and losses of the covered fund. The activity would need to be intended to mitigate risk and be consistent with safety and soundness principles.

D. Request for Comment for Rolling Back Super 23A

The Proposed Revision requests comment on whether to amend prohibitions on transactions between a banking entity and a covered fund for which the banking entity serves as investment manager, investment adviser or sponsor. This restriction, commonly known as "Super 23A," generally prohibits transactions that would be covered under section 23A of the Federal Reserve Act, as implemented by the Federal Reserve's Regulation W.[7] The Agencies specifically seek comment on whether exemptions under Section 23A and Regulation W—such as quantitative limits—should be incorporated into Super 23A instead of the current outright prohibition on covered transactions.

E. Permitted Covered Fund Activities of a Foreign Banking Entity

By statute, the Volcker Rule's prohibitions do not apply to foreign banking entities whose activities and investments occur solely outside of the U.S., subject to certain other conditions. The Proposed Revision removes one of those conditions; specifically, that no financing for the banking entity's

ownership or sponsorship is provided by any branch or affiliate that is located or organized in the U.S. The Proposed Revision would require that:

- the banking entity that acquires interest in the covered fund not be located or organized in the U.S.;
- the banking entity that makes the decision to acquire the interest not be located or organized in the U.S.; and
- the investment or sponsorship is not accounted for as principal by any branch or affiliate of the banking entity that is located or organized in the U.S.

Similar to the proposed revision related to a foreign fund's proprietary trading activity, this modification likely would increase foreign funds' investments, but allow for limited involvement of U.S. affiliates on an investment.

F. Extension of July 21, 2017 No-action Policy Statement

Under the 2013 Rule, certain funds that are not covered funds nonetheless remain subject to the Volcker Rule because they are considered banking entities. This issue has particularly impacted U.S. registered investment companies, foreign public funds and foreign excluded funds. The Agencies released a policy statement on July 21, 2017, providing for no enforcement action until July 21, 2018 for foreign funds whose interest in, or sponsorship of, a foreign fund would meet the requirements for permitted covered fund activities and investments solely outside of the United States, among other conditions. The Proposed Revision extends the effectiveness of that policy statement until July 21, 2019, and requests comment on the issues raised by such Policy Statement.

IV. Conclusion

While the Proposed Revision tinkers with provisions of the Volcker Rule, the Volcker Rule's goal—to prevent banking entities from leveraging government-insured deposits to engage in proprietary trading and acquire interests in a wide range of funds—has not been changed. The Proposed Revision keeps in place the Volcker Rule's primary prohibitions, even for those entities engaged in limited trading activity. Accordingly, in our view, the Proposed Revision does not signal a return to the *laissez faire* pre-crises regime, but instead reflects recognition that the goals of the Volcker Rule can be met through a streamlined, risk-based framework rather than through overbroad, overly proscriptive and onerous regulations. These changes are similar in scope and purpose to the recently adopted Relief Bill, inasmuch as both maintain the core principles of post-crisis reforms while streamlining their application and simplifying their rules, particularly with respect to smaller institutions that do not pose systemic risk to the financial system.

Paul Hastings attorneys are actively working with clients to identify and address issues and risks related to implementation of the Volcker Rule and provide comment to the Agencies in response to the Proposed Revision. We are available to advise you with respect to these matters and the impact of the Proposed Revision on your banking entity's activities.

The chart below is duplicated from the Proposed Revision, as circulated by the Federal Reserve's Vice Chairman for Supervision Quarles to the Board of Governors (May 25, 2018), at 237, 238.

Summary of Proposed Changes to Compliance Program Requirements		
Requirement (Citation to 2013 Final Rule)	**Banking Entities Subject to Requirement in 2013 Final Rule**	**Banking Entities Subject to Requirement in Proposal**
6 Pillar Compliance Program (**Section .20(b)**)	Banking entities with more than$10 billion in total consolidated assets	Banking entities with significant trading assets and liabilities
Enhanced compliance program (**Section .20(c), Appendix B**)	Banking entities with: • $50 billion or more in total consolidated assets, or • Trading assets and liabilities of $10 billion or greater over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, if the banking entity engages in proprietary trading activity permitted under subpart B. • Additionally, any other banking entity notified in writing by the Agency	Not applicable. Enhanced compliance program eliminated (but see CEO Attestation Requirement below).
CEO Attestation Requirement (**Section .20(c), Appendix B**)	Banking entities with: • $50 billion or more in total consolidated assets, or • Trading assets and liabilities of $10 billion or greater over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters. • Additionally, any other banking entity notified in writing by the Agency	• Banking entities with significant trading assets and liabilities • Banking entities with moderate trading assets and liabilities • Any other banking entity notified in writing by the Agency
Metrics Reporting Requirements (**Section .20(d), Appendix A**)	• Banking entities with trading assets and liabilities the average gross sum of which over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, is $10 billion or greater, if the banking entity engages in proprietary trading activity permitted under subpart B. • Any other banking entity notified in writing by the Agency	• Banking entities with significant trading assets and liabilities • Any other banking entity notified in writing by the Agency

Summary of Proposed Changes to Compliance Program Requirements		
Requirement (Citation to 2013 Final Rule)	**Banking Entities Subject to Requirement in 2013 Final Rule**	**Banking Entities Subject to Requirement in Proposal**
Additional covered fund documentation requirements (**Section .20(e)**)	Banking entities with more than $10 billion in total consolidated assets as reported on December 31 of the previous two calendar years	Banking entities with significant trading assets and liabilities
Simplified program for banking entities with no covered activities (**Section .20(f)(1)**)	Banking entities that do not engage in activities or investments pursuant to subpart B or subpart C (other than trading activities permitted pursuant to § .6(a) of subpart B)	Banking entities that do not engage in activities or investments pursuant to subpart B or subpart C (other than trading activities permitted pursuant to § .6(a) of subpart B)
Simplified program for banking entities with modest activities (**Section .20(f)(2)**)	Banking entities with $10 billion or less in total consolidated assets as reported on December 31 of the previous two calendar years that engage in activities or investments pursuant to subpart B or subpart C (other than trading activities permitted pursuant to § ___.6(a) of subpart B)	Banking entities with moderate trading assets and liabilities
No compliance program requirement unless Agency directs otherwise (**N/A**)	Not applicable.	Banking entities with limited trading assets and liabilities subject to the presumption of compliance

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If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings Washington, D.C. lawyers:

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[1] 12 U.S.C. §§ 5301 *et seq.*

[2] 12 C.F.R. Pt 223.

[3] *See* Paul Hastings Stay Current "Reports of Dodd-Frank's Death Are Greatly Exaggerated," (May 2018).

[4] 12 U.S.C. § 1851(h)(4).

[5] 12 U.S.C. § 1851(h)(6).

[6] 15 U.S.C. §§ 80a-1 *et seq.*

[7] 12 C.F.R. Pt. 223.

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