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Proposed revisions to the Volcker Rule — Prohibitions and restrictions on proprietary trading and certain interests in, and relationships with, hedge funds and private equity funds

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On May 30, 2018, the Federal Reserve Board issued a notice of proposed rulemaking[1] and asked for comment on a proposed rule to simplify and tailor compliance requirements relating to the regulation implementing section 13 (commonly known as the "Volcker Rule")[2] of the Bank Holding Company Act ("BHC Act") (the "Proposal").[3]

The Proposal was developed jointly with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (together, the "Agencies").

The Volcker Rule generally prohibits a banking entity from engaging in proprietary trading or acquiring or retaining an ownership interest in, or having certain relationships with, a hedge fund or private equity fund.

In December 2013, the Agencies jointly issued a final rule (the "Final Rule") to implement the requirements of the Volcker Rule. The Volcker Rule generally prohibits a banking entity[4] from engaging in proprietary trading or acquiring or retaining an ownership interest in, or having certain relationships with, a hedge fund or private equity fund (a "covered fund").

The Final Rule also requires firms with significant trading operations to report certain quantitative metrics related to their trading activities and requires banking entities to establish a Volcker Rule compliance program. The Proposal represents a significant reconsideration of the Final Rule and portends a more workable Volcker Rule compliance regime.

Based on several years of experience implementing the Final Rule, the Agencies have introduced proposed changes with the intent of (i) tailoring the requirements of the regulation to focus on entities with large trading operations; and (ii) streamlining and simplifying regulatory requirements by eliminating or adjusting certain requirements and focusing on quantitative, bright-line rules where possible to provide clarity regarding prohibited and permissible activities.

The Proposal identifies opportunities, consistent with the statute, to incorporate additional tailoring of the application of the Volcker Rule based on the activities and risks of banking entities and to provide greater clarity about the activities that are prohibited and permitted. The comment period on the Proposal will be open for sixty (60) days after it is published in the Federal Register.

TAILORING BY SIZE OF TRADING ASSETS AND LIABILITIES — ESTABLISHMENT OF THREE CATEGORIES OF BANKING ENTITIES BASED ON TRADING ACTIVITY

The proposal would establish three categories of banking entities based on trading activity.

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 U.S. or any U.S. agency) equal to or exceeding $10 billion would be required to have a comprehensive compliance program that would be tailored to reflect the requirements of the statute.

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 U.S. or any U.S. agency) less than $10 billion but equal to or above $1 billion would be subject to reduced compliance requirements in light of their relatively smaller and less complex trading activities.

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 U.S. or any U.S. agency) less than $1 billion would enjoy a rebuttable presumption of compliance with the rule.

CHANGES TO PROPRIETARY TRADING RESTRICTIONS

Revised definition of trading account and additional exclusions

Revised Definition of Trading Account

The statutory proprietary trading prohibitions apply to positions taken as principal for the trading account of a banking entity. The statute defines "trading account" as 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), and any other such accounts as the Agencies may by rule determine.

The Final Rule implemented the statutory definition of trading account with a three-pronged definition: (i) "short-term intent prong" (subject to a rebuttable presumption),[5] (ii) the "market risk capital prong" and (iii) the "dealer prong."

The Proposal would replace the short-term intent prong with a prong based on the accounting treatment of a position (the "accounting prong"), while retaining the market risk capital prong[6] 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 Proposal would also eliminate the 60-day rebuttable presumption.

Expanded Liquidity Management Exclusion and New Exclusion for Trade Error Corrections

The proposal would expand the liquidity management exclusion to permit the purchase or sale of foreign exchange forwards, foreign exchange swaps, and physically-settled cross-currency swaps entered into by a banking entity for liquidity management purposes.

The Proposal would add a new exclusion from the definition of proprietary trading for trading errors and subsequent correcting transactions made on by a banking entity as principal to correct erroneously executed trades.

Permitted underwriting and market-making activities RENTD-related presumption

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 exempted from the prohibition on proprietary trading.

The Proposal would provide that the purchase or sale of a financial instrument by a banking entity is presumed not to exceed RENTD if the banking entity establishes underwriting and market-making internal risk limits for each trading desk (subject to certain conditions) and implements, maintains, and enforces those limits, such that the risk of the financial instruments held by the trading desk does not exceed such limits.

Reduced requirements for permitted risk-mitigating hedging activities

The Proposal would remove certain hedging requirements for all banking entities, reduced hedging requirements for banking entities that do not have significant trading assets and liabilities, and reduced hedging documentation requirements for banking entities with significant trading assets and liabilities.

> The proposal represents a significant reconsideration of the final rule and portends a more workable Volcker Rule compliance regime.

Permitted trading activities of a foreign banking entity

Section 13(d)(1)(H) of the BHC Act permits certain foreign banking entities to engage in proprietary trading that occurs solely outside of the United States (the "foreign trading exemption"), subject to certain conditions.

The Proposal would eliminate the requirements that (i) no financing for the banking entity's purchase or sale is provided by any branch or affiliate of the banking entity that is located in the U.S. or organized under the laws of the U.S. or of any state and (ii) the purchase or sale, generally, is not conducted with or through any U.S. entity, and would modify another requirement to focus on whether the banking entity that engages in the purchase or sale as principal (including any relevant personnel) is located in the U.S.

CHANGES TO COVERED FUND ACTIVITIES AND INVESTMENTS

Comments sought on the definition of covered fund

The Final Rule defines covered fund to cover issuers of the type that would be investment companies but for section 3(c)(1) or 3(c)(7) of the Investment Company Act[7] (*i.e.*, hedge

funds and private equity funds), with certain exclusions for specific types of issuers.

Without changing the definition of covered fund, the Proposal seeks comments on whether the definition should be further tailored to exclude certain additional types of funds (such as venture capital funds), whether to define covered fund with reference to certain fund characteristics (an alternative discussed in the preamble to the Final Rule), or whether to reference an existing definition (such as the SEC's Form PF definitions of "hedge fund" and "private equity fund").[8]

Activities permitted in connection with organizing and offering a covered fund

Beneficial treatment of the value of covered fund interests under the underwriting and market-making exemptions

Section 13(d)(1)(B) of the BHC Act permits a banking entity to purchase and sell securities and other instruments in connection with certain underwriting or market-making-related activities.

Under the Final Rule, so long as certain requirements are met, the prohibition on ownership or sponsorship of a covered fund does not apply to a banking entity's underwriting and market-making-related activities involving a covered fund.

The Proposal would, for a covered fund that a banking entity does not organize or offer, remove the requirement that the banking entity include in its aggregate fund limit and capital deduction the value of any ownership interests of the covered fund acquired or retained under the underwriting or market-making exemption in order to facilitate a banking entity's underwriting and market-making related activities for covered funds and to permit a banking entity to hold exposures consistent with the reasonably expected near term demand of clients, customers, and counterparties.

Expanded permitted risk-mitigating hedging activities

Section 13(d)(1)(C) of the BHC Act provides an exemption for certain risk-mitigating hedging activities. The Proposal would expand permitted risk-mitigating hedging activities to allow a banking entity to acquire a covered fund interest as a 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, so long as the activity is designed to mitigate risk.

Limitations on relationships with a covered fund

Comments sought on easing restrictions relating to covered transactions with covered funds

Section 13(f) of the BHC Act generally prohibits a banking entity that serves as investment manager, investment adviser, or sponsor to a covered fund (or that organizes and offers a covered fund pursuant to section 13(d)(1)(G) of the BHC Act) from entering into a transaction with such covered fund that would be a covered transaction as defined in section 23A of the Federal Reserve Act ("Federal Reserve Act").[9]

The Proposal requests comments on whether the exemptions provided in section 23A of the Federal Reserve Act and Regulation W[10] should be incorporated into the Volcker Rule, which would allow banking entities to extend credit to certain covered funds with which they are associated. This reopens a debate that the Final Rule had resolved against permitting the exemptions.

Permitted covered fund activities of a foreign banking entity

Increased parity for foreign banking entities' activities and investments outside of the U.S.

Section 13(d)(1)(I) of the BHC Act permits foreign banking entities to acquire or retain an ownership interest in, or act as sponsor to, a covered fund, so long as those activities and investments occur solely outside the United States and certain other conditions are met (the "foreign fund exemption").

> The proposal would expand the liquidity management exclusion to permit the purchase or sale of foreign exchange forwards, foreign exchange swaps, and physically-settled cross-currency swaps entered into by a banking entity for liquidity management purposes.

The Proposal would remove as a condition of the foreign fund exemption the requirement that no financing for the banking entity's ownership or sponsorship of covered fund interests is provided by any branch or affiliate that is located in or organized under the laws of the U.S. in order to ease the burden on foreign banking entities' operations outside of the U.S. The other conditions of the foreign fund exemption will continue to apply.

Clarification of the SOTUS exemption's marketing restriction

Under the SOTUS (solely outside of the U.S.) covered fund exemption to the Volcker Rule prohibition on banking entities' investments in covered funds, foreign banking entities may invest in a covered fund so long as no ownership interest in the covered fund is offered for sale or sold to a resident of the U.S., known as the marketing restriction.[11]

Under the Proposal, an ownership interest in a covered fund is not offered for sale or sold by the foreign banking entity to a resident of the United States for purposes of the marketing

restriction only if it is not sold and has not been sold pursuant to an offering that targets residents of the U.S.

Comments sought on treatment of non-covered fund mutual funds and extension of no-action policy statement for foreign excluded funds

The Proposal requests comment on how to approach treatment of certain funds, including U.S.-registered investment companies and foreign excluded funds[12], that are excluded from the definition of covered fund but remain subject to the Volcker Rule because they are considered banking entities.[13]

With respect to foreign excluded funds, the Proposal extends until July 21, 2019 the no-action period described in the Federal banking agencies' July 21, 2017 policy statement, assuming certain conditions are met. It had been due to expire on July 21, 2018. During this time the Federal Reserve Board's FAQ #14 will remain in effect.[14]

TAILORED COMPLIANCE PROGRAMS AND PRESUMPTION OF COMPLIANCE FOR SMALLER BANKING ENTITIES

The Proposal attempts to more effectively tailor compliance program and reporting and metric collection requirements for certain banking entities based on their size and the nature of their activities in order to reduce burdens and uncertainty for smaller institutions, and would focus compliance program requirements on banking entities with the most significant and complex trading activities. The Proposal includes three categories.

Banking entities with significant trading assets and liabilities

Banking entities with significant trading assets and liabilities would be subject to the six-pillar compliance program requirement[15], the metrics reporting requirements, the underwriting and market-making compliance program requirements, the covered fund documentation requirements, and the CEO attestation requirement.

Banking entities with moderate trading assets and liabilities

Banking entities with moderate trading assets and liabilities would be required to establish a simplified compliance program and comply with the CEO attestation requirement.

Banking entities with limited trading assets and liabilities

Banking entities with limited trading assets and liabilities would be presumed to be in compliance with the Volcker Rule. These banking entities would not be required to establish a special Volcker Rule compliance program unless the appropriate Agency, based upon a review of the banking entity's activities, determines that the banking entity must establish a simplified compliance program.

SIMPLIFICATION OF REPORTING AND RECORDKEEPING REQUIREMENTS

The Proposal recommends certain amend-ments to Appendix A of the Final Rule to reduce compliance-related inefficiencies.

NOTES

[1] https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180530a1.pdf

[2] Section 13 of the BHC Act was added by section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Pub. L. No. 111-203; *see* Dodd-Frank Act § 619; 12 U.S.C. 1851.

[3] *Available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180530a1.pdf; *see also* Federal Reserve Staff Memo to the Board of Governors (May 25, 2018), *available at* https://www.federalreserve.gov/aboutthefed/boardmeetings/files/board-memo-20180530.pdf.

[4] The Final Rule, consistent with section 13 of the BHC Act, defines the term "banking entity" to include (i) any insured depository institution; (ii) any company that controls an insured depository institution; (iii) any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978; and (iv) any affiliate or subsidiary of any entity described in clauses (i), (ii), or (iii).

[5] The "short-term intent prong" includes any account used by a banking entity to purchase or sell one or more financial instruments principally for the purpose of (a) short-term resale,
(b) benefitting from short-term price movements, (c) realizing short-term arbitrage profits, or
(d) hedging any of the foregoing. The Final Rule included a rebuttable presumption that the purchase or sale of a financial instrument is for the trading account if the banking entity holds the instrument for fewer than 60 days or substantially transfers the risk of the position within 60 days (the 60-day rebuttable presumption). See § __.3(b)(2) of the Final Rule.

[6] The market risk capital prong would be modified to include an account used by a foreign banking entity to purchase or sell one or more financial instruments, if the foreign banking entity is subject to a market risk capital framework imposed by its home country supervisor.

[7] Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, in relevant part, provide exclusions from the definition of "investment company" for (1) any issuer whose outstanding securities are beneficially owned by not more than one hundred persons and that is not making and does not presently propose to make a public offering of its securities (other than short-term paper) (Section 3(c)(1)); or (2) any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers" as defined by section 2(a)(51) of the Investment Company Act, and that is not making and does not at that time propose to make a public offering of such securities (Section 3(c)(7)). *See* 15 U.S.C. 80a-3(c)(1) and (c)(7).

[8] *See* Form PF, Glossary of Terms. Form PF uses a characteristics-based approach to define different types of private funds. A "private fund" for purposes of Form PF is any issuer that would be an investment company, as defined in section 3 of the Investment Company Act, but for section 3(c)(1) or 3(c)(7) of that Act. Form PF defines the following types of private funds: hedge funds, private equity funds, liquidity funds, real estate funds, securitized asset funds, venture capital funds, and other private funds.

[9] 12 U.S.C. 371c.

[10] 12 U.S.C. 371c(d); *see also* 12 CFR 233.41-233.43.

[11] *See* FAQ #13, "SOTUS Covered Fund Exemption: Marketing Restriction."

[12] Foreign excluded funds are certain foreign funds that are excluded from the definition of "covered fund" under the Final Rule with respect to a foreign banking entity.

[13] The Final Rule specifically excludes covered funds from the definition of banking entity.

[14] *See* FAQ #5, "Foreign Public Fund Seeding Vehicles," available at the public websites of the Agencies; FAQ #14, "How does the Final Rule apply to a foreign public fund sponsored by a banking entity?" available at the public websites of the Agencies.

[15] Like the Final Rule, the Proposal would provide that a six-pillar compliance program must include written policies and procedures, internal controls, a management framework, independent testing and audit, training for relevant personnel, and recordkeeping requirements.

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