Volcker 2.0: Agencies Propose to Reduce Regulatory Burdens Imposed by the Volcker Regulations

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June 2018

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After a long lead up, the five agencies (Agencies) with responsibility for the regulations that implement the Volcker Rule (Regulations)[1] have issued a wide-ranging proposal to tailor the application of the Regulations in order to reduce what the Agencies consider to be unnecessary burdens on institutions subject to the Regulations (Proposal).[2]

The Proposal indicates that the Agencies recognize there are a number of opportunities for improvements to the current Regulations. With over 300 specific requests for comment, the Proposal also shows an interest by the Agencies in considering a wide range of recommendations for further improvement of the Regulations.

Although the Proposal would provide regulatory relief and greater clarity in many areas, this regulatory action, if implemented, falls far short of a goal held by many in the industry who hoped for a complete legislative repeal of the Volcker Rule.[3] Ultimately, Congress enacted much more limited changes to the Volcker Rule when it passed the Economic Growth, Regulatory Relief and Consumer Protection Act (Act), which was signed by President Trump on May 24, 2018. The Act exempts banking entities with less than $10 billion in consolidated assets and limited trading activities from the Volcker Rule and narrows the scope of the customer fund naming prohibition.

The recent impetus for reform of the Regulations was triggered by recommendations by the Treasury Department in its Banking and Asset Management reports on regulatory reform in June and October 2017, as well as OCC's August 2017 request for comment on the Regulations.

There will be a 60-day comment period commencing when the Proposal is published in the Federal Register.

Key Proposed Reforms

Significant elements of the Proposal include the following:

- Replacing the short-term trading intent prong of the "trading account" definition with a prong based on accounting principles.
- Establishing presumptions of compliance with the Regulations' underwriting and market making exemptions, based on adherence to internal risk limits.

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1 For a detailed discussion of the Volcker Rule and Regulations, please refer to *Dechert OnPoint*, Volcker Rule Regulations Issued: Understanding the Practical Implications for U.S. and Foreign Banking Entities, Funds and Securitization Vehicles; Ledig, Harris, Vartanian, Rose, Vaughn, Williams, *The Volcker Rule: Commentary and Analysis*, Thomson Reuters (2014).

2 The Agencies are the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodities Futures Trading Commission. The Agencies will coordinate to prepare a final version of the Proposal that will be published in the Federal Register. This *DechertOnPoint* is based on the version of the Proposal released by the Agencies on June 5, 2018.

3 Indeed, such a repeal was part of the Financial CHOICE Act passed by the House of Representatives in June 2017.

- Relaxing the requirements for use of the risk-mitigating hedging exemption.
- Relaxing the requirements for the exemption for foreign banking entities trading outside the United States.
- Making it easier for foreign banking entities to utilize the solely outside the United States exemption for investing in covered funds.
- Eliminating or significantly reducing current compliance program requirements for institutions not deemed to have significant trading assets or liabilities.

This *OnPoint* addresses selected aspects of the Proposal.

Proprietary Trading Issues

Revised Definition of a "Trading Account;" Presumption of Compliance for Entities with Limited Trading Activities

A foundational element of the Regulations' proprietary trading provisions is that they apply to financial instruments that are included in a banking entity's "trading account." The Regulations establish a three-pronged approach to designating financial instruments that fall within the trading account:

- Purchase or sale of financial instruments principally for the purpose of short-term resale or benefitting from actual or expected short-term price movements (Short-Term Prong). The Regulations establish a presumption that a financial instrument held for less than 60 days is part of the trading account.
- Financial instruments subject to the market risk capital requirements (Market Risk Prong).
- Purchases or sales undertaken in connection with activity that requires a banking entity to register as a dealer, a swap dealer or a security-based swap dealer (Dealer Prong).

The Agencies explained that they recognize that banking entities lack clarity as to whether particular purchases and sales of a financial instrument are included under the Short-Term Prong. The Agencies propose to eliminate the Short-Term Prong in order to address concerns about the need for a banking entity to make subjective determinations with respect to each trade the entity conducts. The Agencies also recognize that the 60-day rebuttable presumption may cover activities not intended to be treated as proprietary trading.

The Agencies would retain the Market Risk Prong[4] and the Dealer Prong. The Agencies propose to replace the Short-Term Prong with a new Accounting Prong. Under the Accounting Prong, a financial instrument that is recorded at fair value on a recurring basis under applicable accounting standards would be included in the banking entity's trading account. The Agencies stated that such instruments generally include (but are not limited to) derivatives, trading securities, and available-for-sale securities. The Agencies noted that the revised approach is intended to provide greater clarity and certainty as to what instruments would be included in the trading account, because banking entities should know which instruments are recorded at fair value on their balance sheets.

[4] The Market Risk Prong would be modified so that it would apply to an account used by a foreign banking organization that is subject to capital requirements under a market risk framework established by the home country supervisor and which is consistent with the market risk capital framework published by the Basel Committee.

If the Accounting Prong is adopted, an individual trading desk of a banking entity that is not subject to the Market Risk Prong or Dealer Prong, and which operates within a prescribed profit and loss threshold, would be presumed to be in compliance with the prohibition against proprietary trading.[5]

The applicable Agency would retain the ability to rebut the presumption of compliance, by providing written notice to the banking entity of the Agency's determination that one or more of the banking entity's activities violate the proprietary trading restrictions.

If a trading desk that is operating under the presumption of compliance exceeds the prescribed profit and loss threshold at any time, the banking entity would be required to: (i) promptly notify its regulator; (ii) demonstrate that the trading desk's purchases and sales of financial instruments comply with the proprietary trading restrictions; and (iii) demonstrate how the banking entity will ensure that the trading desk maintains compliance with the proprietary trading restrictions.

Under the Proposal, a trading desk that is not subject to the Market Risk Prong or Dealer Prong, and which exceeds the prescribed profit and loss threshold, would be required to comply with the proprietary trading restrictions.

Expansion of the Exclusion for Liquidity Management

The Regulations exclude from the definition of "proprietary trading" the purchase or sale of securities in accordance with a liquidity management plan. The Agencies noted that banking entities often use foreign exchange forwards, foreign exchange swaps and cross-currency swaps for liquidity management purposes. Under the Proposal, the liquidity management exclusion would be expanded to include the foregoing types of transactions.

Exclusion for Correction of Bona Fide Trade Errors

The Proposal notes that banking entities have expressed concern that corrective transactions taken following an initial trading error could be viewed as proprietary trading that is not otherwise permitted under the Regulations. The Agencies indicated that these types of transactions generally lack the intent captured by the statutory definition of trading account.

Under the Proposal, when a purchase or sale of a financial instrument is made in error by a banking entity in connection with a permitted activity or a subsequent transaction to correct the error, the transaction would not be deemed to be proprietary trading if the erroneously purchased or sold financial instrument is promptly transferred to a separately-managed trade error account for disposition.

The Proposal cautions that the availability of the exclusion would depend on the facts and circumstances. For example, the exclusion would not be available where the banking entity failed to make reasonable efforts to prevent errors from occurring.

5 Under the Proposal, each trading desk that does not purchase or sell financial instruments under the Market Risk Prong or the Dealer Prong may calculate the net gain or net loss on the trading desk's portfolio of financial instruments each business day, reflecting realized and unrealized gains and losses since the previous business day, based on the banking entity's value for such financial instruments. If the sum of the absolute values of the daily net gain and loss figures for the preceding 90 calendar days does not exceed $25 million, the activities of the trading desk would be presumed to be in compliance with the proprietary trading restrictions of the Regulations.

Reservation of Agency Authority to Identify Proprietary Trading Transactions

The proposed move to an Accounting Prong for the trading account definition would reflect a move from a subjective approach under the Short-Term Prong to an objective approach. In this regard, the Agencies propose that they be authorized to determine on a case-by-case basis whether or not the purchase or sale of one or more financial instruments is for the banking entity's trading account.

Under the Proposal, if an Agency determines that a transaction was for a banking entity's trading account, the Agency would provide written notice to the banking entity explaining the basis for this determination. The banking entity would have an opportunity to provide a written response to the Agency, and the Agency would then provide the banking entity with a final decision.

Permitted Underwriting Activities

Presumption of Compliance Based on Internal Risk Limits

The Agencies propose to tailor, streamline and clarify the requirements a banking entity must satisfy in order to utilize the underwriting exemption. In this regard, the Proposal would establish a presumption that trading within internally set risk limits satisfies the statutory requirement that permitted underwriting activities must be designed not to exceed the reasonably expected near-term demands of clients, customers or counterparties (RENTD).

The Agencies commented that the proposed approach to this exemption in the Regulations may be overly broad and complex, and may inhibit permissible underwriting activity.

Under the Proposal, a purchase or sale of financial instrument by a banking entity would be presumed to be designed not to exceed the RENTD, on an ongoing basis, if the banking entity establishes internal risk limits for each trading desk (subject to certain conditions) and implements, maintains and enforces those limits. The Agencies indicated that they expect this approach would provide banking entities with more flexibility and certainty in conducting permissible underwriting.

The Proposal also would require banking entities to establish internal risk limits for each trading desk, which are designed not to exceed the RENTD based on the nature and amount of the trading desk's underwriting activities, taking into account:

- The amount, types and risks of the trading desk's underwriting position;
- The level of exposure to relevant risk factors arising from the underwriting position; and
- The period of time a security may be held.

Banking entities that use this presumption would be required to maintain internal policies and procedures for setting and reviewing desk-level risk limits.

The Agencies noted that the proposed approach would not require that a banking entity's risk limits be based on any specific or mandated analysis as is required under the current Regulations. Instead, the banking entity could establish risk limits according to its own internal analyses and processes in connection with its underwriting activities.

A banking entity would be required to promptly report to the applicable Agency when a trading desk exceeds or increases its internal risk limits. The banking entity would also be required to report any temporary or permanent increase in an internal risk limit.

Internal risk limits established by a banking entity would be subject to review and oversight by the applicable Agency on an ongoing basis. Agency review would be based on whether the internal limits are established based on the statutory standards. The Proposal indicates that so long as a banking entity has established, implements, maintains and enforces such limits, the Agency will presume that all trading activity conducted within the limits meets the requirement that the underwriting activity be based on the RENTD.

The Agencies indicated that they expect to closely monitor and review any instances where a banking entity exceeds a risk limit, as well as any temporary or permanent increase to a trading desk limit. In this regard, an Agency could rebut the presumption of compliance for permissible underwriting activities if the Agency determines that a trading desk is engaging in an activity not based on the desk's RENTD on an ongoing basis. The Agencies would provide notice of any such determination to the banking entity.

Reduced Compliance Program Requirements

The Proposal would implement a tiered approach for the compliance program associated with the underwriting exemption. Banking entities with significant trading assets and liabilities[6] would be required to establish, implement, maintain and enforce a comprehensive internal compliance program as a condition for relying on the underwriting exemption. In contrast, the Proposal would eliminate the exemption's compliance program requirements for banking entities that have moderate or limited trading assets and liabilities.[7] In this regard, the Agencies noted that banking entities which do not have significant trading assets and liabilities may incur compliance program expenses that are disproportionate to the banking entity's trading activity and risk.

Permitted Market Making Activities

Presumption of Compliance Based on Internal Risk Limits

Concerns about the impact of the Volcker Rule's impact on liquidity arising from the implementation of the market making exemption in the Volcker Rule under the Regulations have been one of the leading criticisms of the Regulations. In this regard, the Agencies stated that they have observed that the significant compliance requirements and lack of clear bright lines in the Regulations may unnecessarily constrain market making and that some of the existing requirements are unnecessary to prevent the type of trading activities that the Volcker Rule was designed to

6 A banking entity would be deemed to have significant trading assets and liabilities if: (i) it, together with its affiliates, has trading assets and liabilities the average gross sum of which over the previous consecutive four quarters, measured as of the last day of each of the four previous calendar quarters, equals or exceeds $10 billion; or (ii) the applicable Agency determines that the banking entity should be treated as having significant trading assets and liabilities.

7 A banking entity would be deemed to have limited trading assets and liabilities if the entity, together with its affiliates (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any U.S. agency) has trading assets and liabilities the average gross sum of which over the previous consecutive four quarters, measured as of the last day of each of the four previous quarters, is less than $1 billion, unless the applicable Agency has determined that the banking entity should not be deemed to have limited trading assets and liabilities. A banking entity would be deemed to have moderate trading assets and liabilities if it does not have significant trading assets and liabilities or limited trading assets and liabilities.

prohibit. The Agencies are proposing to take the same general approach to market making that they have proposed with respect to the underwriting exemption.

The Agencies noted that the Regulations provide two factors for assessing whether the financial instruments in the trading desk's market maker inventory are designed not to exceed the RENTD. Those factors are: (i) the liquidity, maturity and depth of the market for the relevant type of financial instrument(s); and (ii) demonstrable analysis of historical customer demand, current inventory of financial instruments, and market and other factors regarding the amount, types and risks of or associated with positions in financial instruments in which the trading desk makes a market.

The Agencies noted that banking entities had expressed the view that the banking entities must engage in complex analyses to meet the "demonstrable analysis" requirement, and may still be unable to gain comfort that their market making-related activity meets the requirements of the market making exemption. Furthermore, the Agencies stated that their experience in implementing the market making exemption indicates that it does not provide bright line conditions under which trading can clearly be classified as permissible market trading.

Under the Proposal, the purchase or sale of a financial instrument would be presumed to be designed not to exceed on an ongoing basis the RENTD, based on the liquidity, maturity and depth of the market for the relevant types of financial instrument, if the banking entity establishes internal risk limits for each trading desk (subject to certain conditions), and implements, maintains and enforces those limits, such that the risk of financial instruments held by the trading desk does not exceed such limits.

The internal risks limits would be based on the:

- Amount, types, and risks of the trading desk's market maker positions;
- Amount, types, and risks of the products, instruments and exposures the trading desk may use for risk management purposes;
- Level of exposures to relevant risk factors arising from the trading desk's financial exposure; and
- Period of time a financial instrument may be held.

The Agencies emphasized that the proposed approach would not require that a banking entity's internal risk limits be based on any specific or mandated analysis as required as required under the Regulations. Instead, a banking entity would establish its internal risk limits according to its own internal analyses and processes.

Under the Proposal, a banking entity would be required to promptly to report to the applicable regulator when a trading desk exceeds its internal risk limits. The banking entity also would be required to report any temporary or permanent increase in an internal risk limit.

While a banking entity would not be required to adhere to any specific, pre-defined requirements for limit-setting process apart from the entity's own ongoing assessment of the amount of activity required to conduct market making activity, the internal risk limits would be subject to review by the applicable Agency on an ongoing basis. The Proposal notes that any review would assess whether the internal limits are based on the statutory standard of the RENTD. The Proposal provides that so long as the banking entity has established and implemented such limits, there is a presumption that all trading activity within the internal limits is conducted in compliance with the exemption. The

Proposal notes that the Agencies would expect to closely monitor any instances of a banking entity exceeding a risk limit or any temporary or permanent increase to trading desk limit.

A presumption of compliance for market making activities may be rebutted by an Agency if it determines, based on all relevant facts and circumstances, that a trading desk is engaged in activity that is not based on the RENTD.

Reduced Compliance Program Requirements

The Regulations require a banking entity that uses the market making exemption to enforce a compliance program that includes a series of required provisions, and which is reasonably designed to ensure compliance with the exemption.

The Agencies noted that banking entities have asserted that the compliance program requirements can be overly complex and burdensome. While the Agencies believe the compliance program is important, they are recommending a tailoring of the requirement.

The Proposal would continue to apply the compliance program requirement to banking entities with significant trading assets and liabilities. However, the requirement would be eliminated for banking entities with moderate or limited trading assets and liabilities – this would not relieve those entities of the obligation to comply with the requirements for the market making exemption, but is intended to allow them to have flexibility to tailor their compliance efforts.

Loan-Related Swaps

The Agencies noted that they have received inquiries from smaller institutions that are not subject to the market risk capital rule and are not dealers, regarding the treatment of certain swaps entered into in with a customer in connection with a loan (Loan-Related Swap). The Agencies stated that a Loan-Related Swap is a financial instrument under the Regulations and would also be a financial instrument under the Proposal. Furthermore, if the Accounting Prong were adopted, any derivative transaction would constitute proprietary trading if it were recorded at fair value on a recurring basis. Thus, the Agencies believe it is likely that Loan-Related Swaps would be considered to be proprietary trading. As a result, in order for the transaction to be permissible, a banking entity would need to rely on an exclusion or exemption.

The Agencies explained that a typical Loan-Related Swap involves the banking entity making a floating rate loan to a customer, then contemporaneously entering into an interest rate swap with the customer and an offsetting swap with another counterparty. Thus, the banking entity has offset its market risk associated with the customer-facing swap but retains counterparty risk from both swaps.

The Agencies noted that some banking entities which infrequently enter into such swaps had asked whether such activity could satisfy the market making exemption requirements. In response, the Agencies noted that for certain banking entities, the relevant market for such transactions may involve minimal demand. Accordingly, the Agencies requested comment as to whether minimal activity meets the requirement that a banking entity routinely stand ready to make a market in such transactions. The Agencies also indicated they would consider: excluding such transactions from the definition of proprietary trading; or creating a new exemption for such transactions.

Permitted Risk-Mitigating Hedging

The requirements established for the risk-mitigating hedging exemption were among the most controversial aspects of the Regulations, as many industry representatives viewed them as unnecessarily restrictive. The Proposal seeks to relax the requirements for the use of this exemption.

Elimination of Correlation Analysis Requirement

Under the Regulations, the Agencies indicated that they expected a banking entity to undertake a correlation analysis to determine whether or not a potential strategy would demonstrably reduce the risk it was designed to address. The Agencies stated that if sufficient correlation could not be demonstrated, they expected that such analysis would explain why not, as well as how the proposed hedging transaction was designed to reduce risk and how that reduction or mitigation could be demonstrated.

The Agencies commented that they had become aware of practical difficulties with the correlation analysis requirement, as banking entities: advised that the requirement can add delays, costs and uncertainty; and questioned the extent to which the analysis helps to ensure the accuracy of the hedging activity. Furthermore, the Agencies described a range of practical difficulties in complying with the correlation analysis requirement. As a result, the Agencies propose to remove this requirement.

Elimination of Continuing Requirement that a Hedging Activity Demonstrably Reduce Specific Risks

The requirement that a risk-mitigating hedging activity demonstrably reduce or otherwise significantly mitigate specific risks is not expressly required by the Volcker Rule. The Agencies commented that, in practice, the requirement can be complex and could potentially reduce *bona fide* risk-mitigating hedging activity. The Agencies noted that it can be difficult in some circumstances to know with sufficient certainty whether a potential hedging activity would continue to demonstrably reduce an identifiable risk after it has been implemented. Moreover, the Agencies observed that certain circumstances (*e.g.*, unforeseen changes in market conditions, event risk, sovereign risk, and other factors that cannot be known in advance) could reduce or eliminate intended hedging benefits.

The Agencies further observed that it may be difficult, if not impossible, for a banking entity to comply with a continuous requirement to demonstrably reduce identifiable risks. Accordingly, the Agencies stated that a banking entity may determine not to enter into what would otherwise be an effective hedge, out of concern that the banking agency might not be able to effectively comply with the continuing hedging requirement if unforeseen risks occur. Thus, the Proposal would eliminate this requirement.

Certain Other Reduced Compliance Requirements

As part of their tailoring of the requirements of the Regulations, the Agencies propose to eliminate certain other elements of the risk-mitigating hedging exemption requirements for banking entities that do not have significant trading assets and liabilities.

Permitted Trading Activities of a Foreign Banking Entity

The Proposal would significantly revise the requirements for certain permissible trading by foreign banking entities, referred to as Trading Outside the United States (TOTUS exemption). The Agencies commented that foreign banking entities had indicated that the requirements to rely on the TOTUS exemption as set forth in the Regulations unduly limited the ability of foreign banking entities to engage in trading intended to be permitted under the Volcker Rule and resulted in an impact on their operations outside the United States broader than necessary to achieve compliance with the Volcker Rule. The Agencies also stated that market participants had indicated that identifying whether financing has been provided by a U.S. affiliate or branch can be exceedingly complex with respect to a particular transaction.

The Agencies are proposing to eliminate the location of financing requirement under TOTUS in response to foreign banking entities' concerns with the difficulty of complying with this requirement. The Proposal would amend the Regulations to focus on the principal risks of a transaction and the locations of the foreign banking entity's decision to trade as a principal – a foreign banking entity would be able to rely on the TOTUS exemption so long as the risks of the transaction are booked outside of the United States. In this regard, the Agencies recognize that a U.S. affiliate that extends financing could bear some risks, but the proposed revisions would still require that the principal risks occur and remain outside the United States.

The Agencies also noted that foreign banking entities had advised that the counterparty limitations of the Regulations have been overly difficult and costly to monitor, track and comply with in practice. The Regulations require that a permissible transaction with a U.S. entity must involve: (i) the foreign operations of a U.S. entity, subject to restrictions on the involvement of U.S. personnel; (ii) a purchase or sale with an unaffiliated market intermediary acting as principal, subject to certain clearing and settlement requirements; or (iii) a purchase or sale with an unaffiliated market intermediary acting as agent, subject to certain clearing and settlement requirements. The Agencies further commented that market participants had indicated that these limitations in practice led foreign banking entities to overly restrict the range of counterparties with which they conduct transactions, as well as disproportionately burdened compliance resources in order to comply with TOTUS when engaging in these transactions

In response, the Agencies propose to eliminate the counterparty limitations. The revised regulations would focus the requirements of the TOTUS exemption on the location of the foreign banking entity's decision to trade as a principal, as well as the principal risks of the purchase or sale, which the Agencies view as most consistent with the applicable language of the Volcker Rule.

The Agencies commented that information provided by foreign banking entities has demonstrated that few trading desks of such entities have utilized the TOTUS exemption. The Agencies stated that this has raised concerns that the Regulations may be overly restrictive of permitted activities. At the same time, the Agencies request comment as to whether the proposed changes would result in disadvantages for U.S. banking entities that compete with foreign banking entities, creating a significant potential for regulatory arbitrage. The Proposal states that the Agencies seek to mitigate this concern through other changes in the Proposal, such as the simplified and streamlined requirements for market making and risk-mitigating hedging.[8]

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8 The Agencies noted that the U.S. and foreign operations of a U.S. banking entity conducting permissible market making-related activities or other permissible activities may engage in those transactions with a foreign banking entity that is engaged in permissible trading under the TOTUS exemption, so long as the U.S. banking entity complies with the market making exemption or other relevant exemption available to the U.S. banking entity. The Proposal would not impose a duty on a foreign or U.S. banking entity to ensure that its counterparty is conducting its activities in conformance with the Volcker Rule and Regulations. Instead, the obligation would be on each party to ensure that it is conducting its own activities in compliance with the Volcker Rule and Regulations.

Issues as to Covered Fund Activities

Definition of Covered Fund; Exclusions from Covered Fund Status

The Volcker Rule generally prohibits banking entities from acquiring or retaining an ownership interest in, or sponsoring, a private equity fund or hedge fund. The Proposal points out that in implementing this prohibition, the Agencies adopted a tailored definition of "covered fund" that applies to 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 (1940 Act), with certain exclusions to focus the definition on vehicles used for the investment purposes that the Agencies believe were the target of the Volcker Rule. The Proposal also acknowledges that tailoring the scope of the definition was intended to allow the Agencies to avoid unintended results that might follow from a definition that was inappropriately imprecise. To that end, the Proposal requests comment on a number of issues related to the covered fund definition, and asks if there are additional exemptions that could be added to reduce any unintended results from the Regulations' definition.

The Proposal seeks comment as to whether: the current definition of covered fund is itself inappropriately imprecise; the existing exclusions should be modified; or other exclusions should be added. With respect to the existing exclusions, the Proposal focuses on refining the exclusions for foreign public funds (FPFs), joint ventures (JVs) and securitizations. In addition, the Proposal seeks comment on whether additional exclusions for family wealth management vehicles should be added, and whether a characteristics-based exclusion would be workable.

Foreign Public Funds

The Regulations provide an exclusion from the definition of "covered fund" for issuers that are organized or established outside of the United States and whose ownership interests are authorized to be offered and sold to retail investors in the issuer's home jurisdiction and which are sold predominantly through one or more public offerings outside of the United States. The Regulations did not define "predominantly through one or more public offerings outside of the United States." However, the Agencies indicated in the final rule that this means that at least 85% of the FPF's interests are sold to non-U.S. investors. The Proposal notes that the reasoning behind the FPF exclusion was to exclude from this definition funds that share the same characteristics as registered investment companies under the 1940 Act (registered funds), but which clearly are not private equity funds or hedge funds and are appropriately excluded from the definition of covered fund.

The Proposal seeks comment on a number of issues related to FPFs, including whether the FPF exclusion is effective in identifying foreign funds that may be sufficiently similar to registered funds. The Proposal acknowledges certain discrepancies between the FPF and registered fund exclusions, including that registered funds are excluded from the definition regardless of whether or not such a fund's securities are publicly offered. Often referred to as "1940 Act-only" funds, these funds are registered under the 1940 Act, but their securities are exempt from registration under the Securities Act of 1933 because they are sold only to accredited investors (often other funds in the same fund complex). 1940 Act-only funds serve many purposes, including for liquidity management or short-term cash management strategies for other funds in a large fund complex. The Proposal appears to be seeking comment as to whether such 1940 Act-only funds should continue to be excluded from the definition of covered fund.

Another important issue as to which the Proposal seeks comment is the exclusion condition that requires an FPF to be allowed to sell securities to retail investors in the "home jurisdiction" in which it is registered. This condition has posed issues for Undertakings for Collective Investment in Transferable Securities (UCITS) and other similar structures because such funds are often organized in Ireland or Luxembourg but are authorized to sell securities to retail investors in other EU Member States. The Proposal acknowledges that UCITS and other similar funds often cannot meet this condition even though they are sold to retail investors in much the same way as registered funds. The Proposal seeks comment on an alternative condition that would modify the home jurisdiction condition to instead require that "the fund must be authorized to offer and sell interests to retail investors in the 'primary jurisdiction' in which the issuer's ownership interests are offered and sold."

Joint Ventures

The Regulations exclude qualifying JVs from the definition of covered fund. To be deemed a JV, a banking entity must ensure that certain conditions are satisfied. These conditions include that the JV: (i) is between the banking entity (or any of its affiliates) and not more than 10 unaffiliated co-venturers; (ii) is in the business of engaging in activities that are permissible for the banking entity, other than investing in securities for resale or other disposition; and (iii) is not, and does not hold itself as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.

The JV conditions were further clarified in the Volcker FAQs,[9] which emphasized the Agencies' concerns that a JV not be used for impermissible securities investment or trading purposes.[10] In addition, the FAQs caution that the Agencies would not expect that a person that does not have some degree of control over the business of the entity to be considered as meeting the test of participating in a JV.

The Proposal seeks comment as to whether there should be changes to Agency positions on: the requirements regarding permissible securities-related activities of a JV; the role that co-venturers must play; and the types of entities that would qualify as a JV.

Securitizations

The Agencies request comment on all aspects of the impact of the Regulations on securitizations. More specifically, the Agencies ask (among other matters): whether the types of assets that can be held by a loan securitization vehicle should be expanded; whether the Agencies should modify the definition of the term "ownership interest" to provide greater clarity to banking entities; and what characteristics should cause a tranche of a securitization to be treated as an ownership interest.

Family Wealth Vehicles

The Agencies noted that some family wealth vehicles would be investment companies but for sections (3)(c)(1) and 3(c)(7) of the 1940 Act, and thus would be covered funds unless they qualify for an exclusion. Accordingly, banking entities that provide services such as acting as an investment manager, investment adviser or commodity trading advisor to a family wealth covered fund would be subject to prohibitions or restrictions on a range of transactions (including under the Super 23A provision of the Regulations). In this regard, the Agencies request comment on the status of family wealth vehicles under the 1940 Act, and whether such vehicles should be excluded from the definition of covered fund.

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[9] Volcker Rule Frequently Asked Questions (FAQs), Number 15, available at Board of Governors of the Federal Reserve System.

[10] For further information, please refer to *Dechert OnPoint*, Opportunities for Banking Entities Under the Joint Venture Provision of the Volcker Regulations.

Characteristics-Based Exclusion

The Agencies also request comment as to whether there should be any exclusions for funds that lack certain characteristics which may be common among private equity or hedge funds. The Agencies noted that, prior to adopting the Regulations, the Agencies considered whether a characteristics-based exclusion would be feasible and decided at the time that: such an exclusion would provide opportunities for evasion; and banking entities would have difficulty analyzing each potential covered fund. However, the Agencies are now requesting comment on whether adopting definitions of private equity fund and hedge fund, as set forth in Form PF, would be a feasible alternative.

Covered Fund Underwriting and Market Making Activities

Currently, the Regulations allow banking entities to hold or retain an ownership interest in a covered fund in connection with the banking entity's underwriting or market making activities related to a customer fund or asset-backed securities issuance, provided certain conditions are met. These conditions include that the value of any ownership interest held or retained by the banking entity must be counted toward: its aggregate fund limit (no more than 3% of the banking entity's Tier 1 Capital may consist of ownership interests in covered funds); its per-fund limit (3% of the value of the fund); and its capital deduction requirements. The Agencies are proposing that for ownership interests held in covered funds in connection with a banking entity's market making and underwriting activities, the value of such ownership interests not be counted towards the aggregate fund limit and capital deduction requirements or per-fund limits, if the covered fund is not sponsored or organized by the banking entity and the banking entity does not act as investment adviser or commodity trading advisor for the covered fund.

The Agencies stated that the proposed change would seek to more closely align (i) the requirements for engaging in underwriting or market making-related activities with respect to ownership interests in a covered fund with (ii) the requirements for engaging in these activities with respect to other financial instruments. The Agencies also reasoned that this change would reduce compliance costs for banking entities that engage in such activities, without exposing banking entities to additional risks beyond those inherent in underwriting and market making-related activities involving otherwise similar financial instruments as permitted by the statute.

Permitted Risk-Mitigating Hedging Activities

The Regulations currently permit banking entities to hold an ownership interest in a covered fund if the ownership interest is held as a *bona fide* hedge to exposure resulting from an employee's compensation arrangement. This exemption is often used to hedge compensation owed by a banking entity to its employees who serve as portfolio managers to funds sponsored or organized by the banking entity. Portfolio manager compensation may often be tied in some form to the performance of the covered fund.

The Agencies are considering adding a second scenario that would allow a banking entity to hold or retain an ownership interest in a covered fund, provided that the ownership interest was acquired to hedge against when the banking entity is "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." The Agencies had considered this change prior to adopting the Regulations and are now revisiting the issue. When originally considered, the Agencies were concerned that these transactions could expose the banking entity to the risks that: a customer will fail to perform, thereby effectively exposing the banking entity to the risks of the covered fund; and a customer's failure to perform may be concurrent with a decline in value of the covered fund, which could expose the banking entity to additional losses.

Permitted Covered Fund Activities Outside of the United States

The Regulations provide that certain banking entities organized outside of the United States may invest in covered funds provided that the activity takes place solely outside of the United States (SOTUS exemption). The SOTUS exemption may be relied upon provided certain conditions are met, including that: no financing for the banking entity's ownership or sponsorship is provided (directly or indirectly) by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State (Financing Prong); and no ownership interest in the covered fund may be sold to a resident of the United States (Marketing Prong).

As with a proposed revision to the TOTUS exemption, the Agencies are proposing to remove the Financing Prong as a condition for relying on the SOTUS exemption, in response to the Agencies' experience that the prong has been difficult to comply with in practice. The Agencies observed that this would streamline the requirements of the exemption, while doing so in a manner that ensures the risk and sponsorship of the activity or investment occurs and resides solely outside of the United States.

In response to comments from the industry, the Agencies issued a Volcker FAQ clarifying that the Marketing Prong applies to a banking entity or its affiliates that sponsor or serve (directly or indirectly) as the Investment manager, investment adviser, commodity pool advisor or commodity trading advisor to a covered fund, and not to a banking entity that is merely planning to invest in the covered fund.[11] The Agencies noted that if the Marketing Prong were applied to the activities of third parties such as the sponsor of a third-party covered fund, the SOTUS exemption might not be available in certain circumstances where the risks and activities of the investing foreign banking entity are solely outside the United States. The Agencies propose to codify this guidance in the FAQ.

Issues as to Banking Entity Status of Certain Excluded Funds

An issue of lingering concern for many bank-sponsored investment funds that have been excluded from covered fund status is whether those funds might be deemed to be banking entities and themselves subject to restrictions on proprietary trading. The potential for such a result arises from the Volcker Rule's definition of a banking entity to include any entity that is controlled by a banking entity. Moreover, given the Bank Holding Company Act's broad definition of control, there are many scenarios in which the sponsoring banking entity or an affiliate may, in the ordinary course of its investment management activities, be considered to control the fund it sponsors. This risk has been identified as a concern not only by "foreign excluded funds" (*i.e.*, those non-U.S. funds that have been sponsored by a non-U.S. banking entity and are offered only to non-U.S. investors), which fall outside the definition of a covered fund, but also by registered funds and FPFs, both of which are expressly excluded from the definition of a covered fund.

The Agencies previously addressed through FAQs some (but not all) of the concerns raised by registered funds and FPFs. The Agencies by contrast have not issued an FAQ with respect to the treatment of foreign excluded funds. However, the federal banking agencies on July 21, 2017 released a policy statement providing that, during the one-year period ending on July 21, 2018, such agencies would not take enforcement action against foreign excluded funds that meet the conditions of the policy statement.

Although there had been some hope that the Agencies would invite comment on specific proposals to address the concerns of the foreign excluded funds, the Agencies ultimately only requested further comment on the issues.

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11 FAQ Number 13.

Fortunately, the Agencies did extend the no-action period from the policy statement for one additional year to July 21, 2019, and also noted that the FAQs would remain in effect during this time.

Compliance Program Changes

The Agencies propose to take a three-tiered revised approach to the specific compliance program requirements currently contained in the Regulations. Under the Proposal:

- Banking entities with significant trading assets and liabilities would be required to maintain a six-pillar compliance program commensurate with the size, scope and complexity of their activities.

- Banking entities with moderate trading assets and liabilities would be required to include in their existing compliance policies appropriate references to the Volcker Rule and Regulations as appropriate given the size, scope and complexity of their activities.

- Banking entities with limited trading assets and liabilities would be subject to a rebuttable presumption of compliance with the Regulations.

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