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For more information, contact:

George Williams
+1 212 556 2122
gwilliams@kslaw.com

Michael Urschel
+ 1 212 556 2285
murschel@kslaw.com

Terry Novetsky
+1 212 556 2328
tnovetsky@kslaw.com

Jeffrey Misher
+1 212 556 2271
jmisher@kslaw.com

Matthew Sandiford
+1 404 572 2739
msandiford@kslaw.com

Ryan McNaughton
+1 202 556 2244
rmcnaughton@kslaw.com

Anthony Mechcatie
+1 212 556 2104
amechcatie@kslaw.com

King & Spalding

New York
1185 Avenue of the Americas
New York, New York 10036-4003
Tel: +1 212 556 2100

# Right Sizing Volcker

The five agencies that adopted and administer the Volcker Rule[1] have proposed to revise it.[2] Interestingly, however, the proposed revisions make up a surprisingly small part of the release, much of which consists of questions regarding changes other than those proposed in the release, that might be considered worthwhile.[3] Without suggesting that any responses to the more general requests for comment will necessarily result in changes, the release essentially enquires about the general manner in which the Volcker Rule implements section 13 of the Bank Holding Company Act[4] and the usefulness, necessity and effectiveness of many of the Rule's detailed provisions regarding both proprietary trading and the relationships between banking entities and covered funds.

The changes actually proposed by the release relate more to proprietary trading, underwriting, market making, hedging and the related compliance mechanisms both by themselves and in relation to covered funds than they do to other aspects of sponsoring, owning and operating covered funds. In conjunction with more general efforts to allocate supervisory resources where they are most needed,[5] the proposed changes would stratify compliance requirements according to the consolidated trading assets and liabilities of banking organizations. Those with trading assets and liabilities in excess of $10 billion would be subject to the most stringent requirements. Trading assets and liabilities of more than $1 billion but not more than $10 billion would subject a banking organization to fewer obligations, while banking organizations with trading assets of $1 billion or less would be presumed compliant unless determined not to be.[6]

With the declared aim of rendering compliance and the supervision of compliance more manageable, the definition of "trading account" – in the sense of the sum of all assets and liabilities subject to the Volcker Rule provisions governing proprietary trading – is proposed to be modified by eliminating the use of a 60-day holding period as part of the definition and by adding a category for purchases and sales of financial instruments that are "recorded at fair value on a recurring basis under applicable accounting standards."[7] Purchases and sales of financial instruments as part of a business of being a securities, swap or security-based swap dealer would continue to count as part of a trading account. In addition, compliance

would be presumed if sum of the of the absolute values of daily net gain and net loss positions for the preceding 90 calendar days does not exceed $25 million. If that threshold is breached, the banking organization must demonstrate compliance. Although no changes are proposed, comment is requested on the definition of the institutionally more specific notion of “trading desk,” since much of the required recording and reporting activities center around the specific desks and their practices, as opposed to the more general notion of trading account.

Among the other changes proposed in the release are several relating to risk-mitigating hedging, underwriting and market making and related compliance measures and practices. In addition, material is proposed to be added that derives from an FAQ regarding the definition of “solely outside of the United States” in connection with the acquisition by foreign banking organizations of interests in covered funds. The risk-mitigating hedging provisions would adjust the manner in which banking entities conduct and maintain compliance with respect to such activities, both in general and in connection with the ownership of interests in covered funds. The proposals relating to underwriting and making markets in interests in covered funds would require conformity with the proposed new general rules governing such activities; they would also eliminate, for entities other than sponsors, advisers or securitizers of a covered fund or their affiliates, the requirement that interests in such fund held in connection with underwriting or market making be counted toward the aggregate limit (but not the per fund limit) on holding such interests. The amendments proposed for the compliance and reporting provisions in section __.20 and the Appendix to the Volcker Rule are intended to lighten the burdens of less active traders and provide more specific direction regarding the records to be maintained.

The requests for comments on issues that are not the subject of proposals are extensive, implying at least a general willingness to reconsider many aspects of the Volcker Rule. Any substantial change would presumably have to overcome substantial obstacles, including the unclear intended scope of section 13, in particular with respect to the use of the terms “hedge fund” and “private equity fund” to identify covered funds. The rule adopted by the agencies focuses on the part of the statutory definition that refers to sections 3(c)(1) and 3(c)(7) of the Investment Company Act rather than on any substantial or activity-based understanding of what it is that gives such funds their names. Using these statutory references as the basis for the definition of “covered fund” drives a search for ways to limit their (over)generality, and this search basically reveals some basic uncertainty about the exact nature and extent of the difficulties the statute was drafted to cover. Any fundamental change in that approach would not only have to provide a framework that is “better” in some theoretical or policy sense but also be workable in its implementation and be capable of being adjusted to retain those effects of the Volcker Rule that the agencies consider beneficial and eliminate those that are unintended, harmful or inadequately beneficial.

Some of the requests for comment in fact seek views on the possible use of the Security and Exchange Commission’s definitions of “hedge fund” and “private equity fund” as a starting point for re-structuring the treatment of covered funds. Any such shifting of the definitional starting point would have to rely in part on the fact that, after first referring to sections 3(c)(1) and 3(c)(7), the definition of “hedge fund” and “private equity fund” in section 13(h)(2) continues with the phrase “or such similar funds” as the agencies may determine. The use of “or” rather than “and” is helpful even though “or” is often used to mean “and/or.” Although the outcome of any deliberations on this basic point is uncertain, working through them could have an advantage that is not mentioned in the release, namely discussing the way responses to the financial crisis were allocated between the Volcker Rule and risk-retention and using that discussion to more carefully decide which problems can best be dealt with by risk retention or disclosure and which by defining a class of covered funds.

The responses to other requests for comment regarding covered funds raise issues as fundamental as those that relate to their definition, but the cumulative importance of a number of modest changes could be substantial. Some of these changes would retain their usefulness even if the definition of “covered fund” were revised. The issues on which comment is requested include the following:

- The agencies' approach to the permissible seeding periods for covered funds and their treatment of various aspects of non-US fund activities;
- The current version of the exclusion of covered funds from the definition of "banking entity," an issue which relates generally to the question of how broadly the effects of being a banking entity should be imposed or transmitted through various types of affiliations;
- The usefulness and adequacy of the existing exclusion for joint ventures;
- The advisability of allowing a bucket of debt securities to be held by a fund relying on the loan securitization exemption;
- The advisability of including certain voting rights as constitutive of an ownership interest in a covered fund;
- The difficulty of deciding whether some debt-like interests should be treated as ownership interests;
- The proper treatment of small business investment companies that have voluntarily surrendered their licenses;
- The advisability of allowing the various exemptions and quantitative limits to the affiliate transaction rule in section 23A of the Federal Reserve Act to apply in connection with section __.14 of the Volcker Rule (the so-called "Super 23A"); and
- The need for any changes to the definition of "prime brokerage transaction."

Comments must be received no later than September 17, 2018.

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[1] The Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission.
[2] 83 *Fed. Reg.* 33432 (July 17, 2018).
[3] The release contains 342 questions.

[4] 12 USC § 1851.
[5] For a recent example, *see* the speech by Randall K. Quarles, Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, delivered on July 18, 2018 to the American Bankers Association Summer Leadership Meeting and entitled “Getting it Right: Factors for Tailoring Supervision and Regulation of Large Financial Institutions,” available at https://www.federalreserve.gov/newsevents/speech/quarles20180718a.htm.
[6] For foreign banking organizations the $1 billion threshold would be calculated using worldwide consolidated trading assets and liabilities.
[7] 83 *Fed. Reg.* at 33438.