Client Alert

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Agencies Propose Conforming Amendments to Volcker Rule Regulations

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On December 18, 2018, five federal agencies (the "Agencies")[1] released a proposed rule ("Proposed Rule") to conform the regulations implementing the Volcker Rule[2] to statutory modifications provided by Sections 203 and 204 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Regulatory Relief Act").[3] The Proposed Rule will not change the manner in which the Volcker Rule is currently administered, since the relevant provisions of the Regulatory Relief Act were effective upon enactment.[4] The Agencies invite comment on the Proposed Rule within 30 days after the date of publication in the *Federal Register*.

The Volcker Rule generally prohibits banking entities[5] from engaging in proprietary trading and from investing in, sponsoring, or having certain relationships with, private equity funds and hedge funds. In 2013, the Agencies adopted regulations to implement the Volcker Rule.[6] Since that time, banking entities subject to the Volcker Rule have found compliance with its restrictions quite burdensome, and the regulations exceedingly complex. And as a policy matter, since smaller community banks are generally not engaged in the types of activity covered by the Volcker Rule, questions have been raised as to whether the costs of applying the rule to such institutions outweigh the benefits.

Policymakers have taken a number of recent steps to respond to these considerations. In May of this year, Congress adopted the Regulatory Relief Act, which provides the statutory basis for the Proposed Rule. This was soon followed in June by a proposal released by the Agencies that, if adopted, would amend the regulations implementing the Volcker Rule in several material respects.[7] In the June proposal, the Agencies acknowledged

[1] The five federal agencies (i.e., the Agencies) responsible for implementing the Volcker Rule are: the Office of the Comptroller of the Currency; the Board of Governors of the Federal Reserve System ("Federal Reserve"); the Federal Deposit Insurance Corporation; the U.S. Securities and Exchange Commission; and the U.S. Commodity Futures Trading Commission.

[2] The "Volcker Rule" is the common name for Section 13 of the Bank Holding Company Act of 1956, as amended.

[3] The Regulatory Relief Act was enacted on May 24, 2018. For our client alert regarding the Regulatory Relief Act, please see: https://www.mofo.com/resources/publications/180522-financial-regulatory-reform.html.

[4] The Agencies also previously confirmed that the regulations would not be enforced in a manner inconsistent with the statute. *See* "Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds," 83 Fed. Reg. 33434 (July 17, 2018) ("The Agencies also note that the [Regulatory Relief Act] amends section 13 of the BHC Act by narrowing the definition of banking entity and revising the statutory provisions related to the naming of covered funds….The amendments took effect upon enactment, however, and in the interim between enactment and the adoption of implementing regulations, the Agencies will not enforce the 2013 final rule in a manner inconsistent with the amendments to section 13 of the BHC Act with respect to institutions excluded by the statute and with respect to the naming restrictions for covered funds.").

[5] 12 C.F.R. § 248.2(c) (defining the term "banking entity"). See below for further discussions regarding the definition of "banking entity."

[6] *See* "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds; Final Rule," 79 FR 5535 (Jan. 31, 2014) (the "Final Rule"). All citations to the Final Rule in this client alert are to the Final Rule as codified by the Federal Reserve in 12 C.F.R. Part 248.

[7] *See* supra note 4. For our client alert discussing the June proposal, please see: https://www.mofo.com/resources/publications/180619-volcker-rule.html.

the statutory changes to the Volcker Rule enacted by the Regulatory Relief Act but announced that conforming changes to the regulations would be made through a separate rulemaking.

Now, the Agencies have released the Proposed Rule which, consistent with the Regulatory Relief Act, would amend the regulations in two respects. First, the Proposed Rule would incorporate the Regulatory Relief Act's exclusion of certain community banks from coverage of the rule. Second, the Proposed Rule would incorporate the Regulatory Relief Act's provision alleviating the restrictions on banking entities using the same name as hedge funds and private equity funds.

COMMUNITY BANK EXCLUSION

Only "banking entities" are subject to the Volcker Rule. A "banking entity" is defined in the existing regulations to include:[8]

(1) Any insured depository institution (IDI);
(2) Any company that controls an IDI;
(3) Any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978 (i.e., "foreign banking organization"); and
(4) Any subsidiary or affiliate of the above.

The Proposed Rule would exclude community banks that meet certain criteria from the definition of "banking entities." Specifically, an institution would not be considered an IDI for purposes of the definition of a "banking entity" if the institution, and any company that controls the institution, has both (i) total consolidated assets of $10 billion or less; and (ii) total trading assets and trading liabilities, on a consolidated basis, that are 5% or less of total consolidated assets.[9]

Since the enactment of the Regulatory Relief Act, there has been some debate about whether Section 203 of the Regulatory Relief Act should be literally read to exclude from the Volcker Rule institutions of any size as long as their trading assets and liabilities are 5% or less of total consolidated assets. This reading would be at odds with the legislative history of the Regulatory Relief Act and is rejected by the Proposed Rule.[10]

NAMING RESTRICTION

The Volcker Rule restricts the ability of a banking entity to use the same name as a private equity fund or hedge fund. This restriction appears in two places in the Volcker Rule: (i) as a condition to an exemption referred to as the "Asset Management Exemption;" and (ii) within the definition of the term "sponsor."

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[8] 12 C.F.R. § 248.2(c).

[9] The community bank exclusion is not available for foreign banking organizations that are banking entities because they are treated as banking holding companies pursuant to Section 8 of the International Banking Act of 1978.

[10] See also "Statement by FDIC Board Member Martin J. Gruenberg," (Dec. 18, 2018), *available at*: https://www.fdic.gov/news/news/speeches/spdec1818a.pdf?source=govdelivery&utm_medium=email&utm_source=govdelivery (noting that "this statutory exemption, and the proposed implementing regulation that is before the FDIC Board today, apply only to banking organizations with $10 billion or less in total consolidated assets and that the limitation on trading assets and liabilities is an additional limitation placed on this defined group of banking organizations.")

Asset Management Exemption

As long as all of its many conditions are met, the Asset Management Exemption permits banking entities to invest in, sponsor, organize, and offer hedge funds and private equity funds, if such funds are organized and offered only in connection with bona fide trust, fiduciary, investment advisory, or commodity trading advisory services on behalf of customers.[11] One of the conditions of the Asset Management Exemption is that the hedge fund or private equity fund may not use the same name (or a variation thereof) as the banking entity or any of its affiliates.[12]

The Proposed Rule would amend the regulations to incorporate the Regulatory Relief Act's liberalization of this condition. Specifically, under the Proposed Rule, a banking entity that serves as an investment advisor to a covered fund[13] would be permitted to use the same name as such fund and still rely on the Asset Management Exemption (assuming all other conditions are met) if the banking entity (i) is not an IDI, does not control an IDI, and is not a foreign banking organization; and (ii) does not use the same name (or a variation thereof) as an IDI, a company that controls an IDI, or a foreign banking organization. In addition, as is the case under the existing regulations, the Proposed Rule would not permit a covered fund to use the term "bank" in its name, where the banking entity sponsoring, organizing, offering or investing in the covered fund relies on the Asset Management Exemption.

Sponsor

The Volcker Rule and its implementing regulations prohibit banking entities from serving as the "sponsor" of a hedge fund or private equity fund, unless an exemption or exclusion applies.[14] Prior to the Regulatory Relief Act, a banking entity was deemed to be a sponsor of a hedge fund or private equity fund if it used the same name as the fund (or a variation thereof) for corporate, marketing, promotional or other purposes.[15]

The Regulatory Relief Act liberalized the naming restriction contained in the definition of the term "sponsor" to the same extent as the restriction was liberalized for the Asset Management Exemption. In other words, under the Regulatory Relief Act, as long as the two conditions described above are met, and the fund does not contain the word "bank," a banking entity can use the same name as a hedge fund or private equity fund and not be deemed to be the sponsor of such fund (unless it meets the other prongs of the "sponsor" definition). The Proposed Rule would adopt the same approach in the regulations.

[11] 12 U.S.C. § 1851(d)(1)(G); *see also* 12 C.F.R. § 248.11(a).

[12] 12 U.S.C. § 1851(d)(1)(G)(vi); *see also* 12 C.F.R. § 248.11(a)(6).

[13] The term "covered fund" is used in the regulations implementing the Volcker Rule to include hedge funds and private equity funds. *see* 12 C.F.R. § 248.10(b)(defining "covered fund").

[14] 12 U.S.C. § 1851(a)(1)(B); *see also* 12 C.F.R. § 248.10(a).

[15] 12 U.S.C. § 1851(h)(5)(C); *see also* 12 C.F.R. § 248.10(d)(9)(iii).

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