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Agencies Propose Amendment to, and Seek Comment on, Regulations Implementing the Volcker Rule

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On May 30, 2018, the Board of Governors of the Federal Reserve System ("Federal Reserve") issued a proposal (the "Proposed Rule")[1] to amend the rules implementing Section 13 of the Bank Holding Company Act of 1956 (the "Volcker Rule"). Shortly thereafter, the other four federal agencies responsible for implementing the Volcker Rule (together with the Federal Reserve, the "Agencies") followed suit.[2]

The Volcker Rule generally prohibits banking entities[3] from engaging in proprietary trading and from investing in, sponsoring, or having certain relationships with covered funds. In 2013, the Agencies adopted regulations to implement the Volcker Rule (the "Current Rule"). Banking entities have found the Current Rule's restrictions unduly complex and compliance burdensome. In the preamble to the Proposed Rule, the Agencies acknowledge that certain components of the Current Rule have been difficult to implement in practice and so they have identified opportunities for improvement that are consistent with the statute.

In general, the Proposed Rule would provide regulatory relief to banking entities subject to the Volcker Rule by tailoring its application, simplifying certain standards and requirements, and reducing compliance burden. The Proposed Rule would also codify certain guidance previously published in the form of Frequently Asked Questions ("FAQs").[4] In addition, the Proposed Rule solicits comments on a broad range of questions regarding the operation and coverage of the Current Rule and the changes suggested by the Proposed Rule.

On May 24, 2018, the President signed into law S. 2155, the "Economic Growth, Regulatory Relief, and Consumer Protection Act," which makes certain statutory changes to the Volcker Rule.[5] Such changes include an exemption from the Volcker Rule for insured depository institutions that: (i) have $10 billion or less in total consolidated assets; and (ii) have total trading assets and trading liabilities that are less than 5% of total consolidated assets. S. 2155 also permits certain banking entities to share the same name as a covered fund it sponsors or advises and still rely on the asset management exemption. The Agencies plan to address these statutory amendments in a separate rulemaking. While the separate rulemaking process is pending, the Agencies will enforce the Volcker Rule in a manner consistent with S. 2155.

Below is a discussion of the changes set forth in the Proposed Rule, which are classified into three categories: (1) proposed changes to tailor the application of the Volcker Rule; (2) proposed changes with respect to provisions of general applicability; and (3) proposed changes affecting foreign banking entities.

PROPOSED CHANGES TO TAILOR THE APPLICATION OF THE VOLCKER RULE

The Proposed Rule would segment banking entities based on their level of trading assets and liabilities. Banking entities with higher levels of trading assets and liabilities would be subject to more stringent requirements.

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To effect this tailored approach, the Proposed Rule would establish the following three categories:

- **Significant Trading Assets and Liabilities**. A banking entity would be in this category if either: (i) the banking entity (together with its affiliates and subsidiaries) has an average gross sum of trading assets and liabilities over the previous consecutive four quarters equal to or greater than $10 billion; or (ii) the applicable Agency has determined that the banking entity should be treated as having significant trading assets and liabilities. The calculation of trading assets and liabilities would exclude trading assets and liabilities involving obligations of, or guaranteed by, the United States or any agency of the United States. For U.S. banking entities, trading assets and liabilities are measured on a worldwide consolidated basis. For foreign banking organizations ("FBOs"),[6] or subsidiaries of FBOs, trading assets and liabilities would be calculated as the trading assets and liabilities of the combined U.S. operations (including all U.S. subsidiaries, affiliates, branches, and agencies) of the top-tier FBO.

- **Moderate Trading Assets and Liabilities**. A banking entity would have moderate trading assets and liabilities if it neither falls within the category of "limited trading assets and liabilities," described below, nor falls within the category of "significant trading assets and liabilities," described above.

- **Limited Trading Assets and Liabilities**. A banking entity would be in this category if the banking entity (together with its affiliates and subsidiaries) has an average gross sum of trading assets and liabilities over the previous consecutive four quarters of less than $1 billion. For this category, trading assets and liabilities are measured on a worldwide consolidated basis, and trading assets and liabilities involving obligations of, or guaranteed by, the United States or any agency of the United States are excluded.

Under the Proposed Rule, banking entities with limited trading assets and liabilities would be presumed to be compliant with the Volcker Rule and would not have an obligation to demonstrate compliance on an ongoing basis. However, the applicable Agency may require a banking entity with limited trading assets and liabilities to comply with any requirements applicable to banking entities with moderate or significant trading assets and liabilities.

The tailored approach is most relevant for application of the compliance program requirements. However, the Proposed Rule's tailored approach also has implications for the exemptions from the prohibition on proprietary trading for underwriting, market making, and hedging. The chart on the following pages summarizes the implications of the tailored approach in the Proposed Rule for banking entities with significant trading assets and liabilities and banking entities with moderate trading assets and liabilities.

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Current Requirement	Tailored Approach Based on Level of Trading Assets and Liabilities	
	Significant	Moderate
Volcker Rule Compliance Program Requirements		
Volcker Rule compliance program requirements with respect to: (i) written policies and procedures; (ii) internal controls; (iii) management framework; (iv) independent testing and audit; (v) training; and (vi) recordkeeping.[7]	Applicable.	Not applicable.
Enhanced compliance program for large and active banking entities.[8]	Not applicable.	Not applicable.
CEO attestation that banking entity has processes in place reasonably designed to achieve compliance.	Applicable.	Applicable.
Metrics reporting for certain active banking entities.[9]	Applicable (as amended).[10]	Not applicable (unless notified in writing).
Covered funds documentation requirements.[11]	Applicable.	Not applicable.
Proprietary Trading – Underwriting Exemption[12]		
Banking entity must maintain a specified compliance program.[13]	Applicable.	Not applicable.
Proprietary Trading – Market-Making Exemption[14]		
Banking entity must maintain a specified compliance program.[15]	Applicable.	Not applicable.
Proprietary Trading – Risk-Mitigating Hedging Exemption		
Banking entity must maintain a specified compliance program.[16]	Applicable.	Not applicable.
Hedging activity must be conducted in accordance with required written policies, procedures, and internal controls.[17]	Applicable.	Not applicable.

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Current Requirement	Tailored Approach Based on Level of Trading Assets and Liabilities	
	Significant	Moderate
Proprietary Trading – Risk-Mitigating Hedging Exemption (Cont.)		
At inception, hedging must be **designed** to mitigate specific, identifiable risks.[18]	Applicable.	Applicable.
Risk-mitigating hedging activity **demonstrably** reduces or otherwise significantly mitigates specific risks.[19]	Not applicable.	Not applicable.
Hedging must be subject to continuing review, monitoring, and management.[20]	Applicable.	Not applicable.
Hedging must be subject to ongoing recalibration to ensure the activity satisfies the requirements of the exemption and is not prohibited proprietary trading.[21]	Applicable.	Applicable.
Enhanced documentation requirements for certain hedging activity.[22]	Applicable, but an exemption from required documentation is available for hedging of pre-approved, commonly used financial instruments that complies with certain hedging limits.	Not applicable.
Correlation analysis.[23]	Not applicable.	Not applicable.
Compensation arrangements of persons performing risk-mitigating hedging activities are designed not to reward or incentivize prohibited proprietary trading.[24]	Applicable.	Not applicable.

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PROPOSED CHANGES WITH RESPECT TO PROVISIONS OF GENERAL APPLICABILITY

"Trading Account" Definition

Proprietary trading is defined in the Current Rule as "engaging as principal for the *trading account* of the banking entity in any purchase or sale of one or more financial instruments."[25] Under the Current Rule, a banking entity is deemed to be trading for its own trading account if: (i) the trade is for a certain purpose (the "Purpose Test"); (ii) the banking entity is subject to the U.S. market risk capital rules and the account is used to trade financial instruments that are both market risk capital rule covered positions and trading positions or hedges of other market risk capital rule covered positions (the "Market Risk Capital Rule Test");[26] or (iii) the trade is by a securities dealer or other specified entity (the "Status Test"). In addition, a trade is presumed (subject to rebuttal) to be for the trading account if the banking entity holds the financial instrument (or the risk of the trade) for fewer than 60 days. [27]

Under the Purpose Test, a trade is deemed to be for a trading account if the purpose of the trade is for: (i) short-term resale; (ii) benefitting from actual or expected short-term price movements; (iii) realizing short-term arbitrage profits; or (iv) hedging a trade that was made for one of the aforementioned purposes.[28]

Banking entities have found it difficult to analyze the purpose of trades under the Purpose Test. Because of this, the determination of whether a trade is in the trading account often reverts to the rebuttable presumption described above, which may be difficult to rebut.

To address these issues, the Proposed Rule eliminates the Purpose Test. In its place, the Proposed Rule would add a new prong to the definition of trading account that is based on accounting standards. Specifically, under the new "Accounting Test," an account that is used to effect trades will be for the banking entity's trading account if the trade is "with respect to a financial instrument that is recorded at fair value on a recurring basis under applicable accounting standards."[29] This would include financial instruments such as derivatives, trading securities, and available-for-sale securities.[30] The Agencies request comment on whether this is a workable standard.

Presumption of Compliance for Minimal Activities

If a banking entity is not deemed to be engaged in proprietary trading under the Market Risk Capital Rule Test or the Status Test, the Proposed Rule would add a presumption that a trading desk is in compliance with the prohibition on proprietary trading if the sum of the absolute values of the daily net gain and loss of a trading desk's portfolio for the preceding 90 days is $25 million or less. A banking entity may calculate "the net gain or 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 fair value for such financial instruments."[31] This presumption may be rebutted by the applicable Agency if it has determined that the banking entity's activities violate the prohibitions on proprietary trading.

Reasonably Expected Near Term Demand

The Volcker Rule permits certain underwriting and market-making activity to the extent such activities are designed not to exceed the reasonably expected near term demands ("RENT-D") of clients, customers, or counterparties. The Current Rule sets forth conditions that must be met and standards used by a banking entity to determine whether activities meet the RENT-D requirement. The Agencies acknowledge that the approach taken

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in the Current Rule "may be overly broad and complex, and also may inhibit otherwise permissible" underwriting and market-making activity.[32]

As a result, the Proposed Rule would create a presumption of compliance with the RENT-D requirements for both the underwriting and market-making exemptions. To satisfy the presumption, banking entities would be required to establish internal risk limits for each trading desk designed not to exceed the RENT-D of clients, customers, or counterparties, based on the nature and amount of the trading desk's underwriting or market-making activities, as applicable.

With respect to underwriting activities, internal risk limits would be placed on: (i) the amount, types, and risk of the trading desk's underwriting position; (ii) the level of exposures to relevant risk factors arising from its underwriting position; and (iii) the period of time a security may be held.

With respect to market-making activities, internal risk limits would be placed on: (i) the amount, types, and risks of its market maker positions; (ii) the amount, types, and risks of the products, instruments, and exposures the trading desk may use for risk management purposes; (iii) the level of exposures to relevant risk factors arising from its financial exposure; and (iv) the period of time a financial instrument may be held.

For both underwriting and market making, reliance on the presumption would require the maintenance of certain policies and procedures. In addition, in both cases, the banking entity would be required to make a report to the appropriate Agency if: (i) a trading desk exceeds or increases its internal risk limits; or (ii) the banking entity temporarily or permanently increases the internal risk limits. The risk limits would be subject to review and oversight by the appropriate Agency, but there would be no specific, pre-defined processes for setting the limits.

Additional Exclusions From Proprietary Trading

The Proposed Rule would add additional exclusions to the prohibition on proprietary trading.

- *Expansion of Liquidity Management Plan Exclusion.* The Current Rule excludes from the definition of proprietary trading the purchase or sale of a security for liquidity management purposes in accordance with a documented liquidity management plan that meets certain requirements. The Proposed Rule would expand this exclusion to apply to the trading of foreign exchange forwards, foreign exchange swaps, and physically settled cross-currency swaps pursuant to such a liquidity management plan.

- *Erroneous Trades.* The Proposed Rule would exclude from the definition of proprietary trading any trades made in error in the course of conducting a permitted or excluded activity as well as any subsequent transaction to correct the error. To rely on this exclusion, the erroneous trade must be transferred to a separately-managed trade error account for disposition. The availability of the exclusion will depend on the facts and circumstances of any given transaction.

Underwriting and Market Making of Ownership Interests in Covered Funds

The Current Rule exempts the underwriting and market making of ownership interests of covered funds conducted in accordance with specific exemptions from the prohibition on proprietary trading.[33] The exempt activity is subject to: (i) a per-fund limitation on the percentage ownership of each fund in which a banking entity holds investments; and (ii) a limitation on the value of ownership interests so acquired based on the banking entity's capital. In this last regard, the aggregate value of a banking entity's and its affiliates' ownership interests in

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covered funds may not exceed 3% of the banking entity's tier 1 capital.[34] In addition, for purposes of calculating regulatory capital requirements, a banking entity is generally required to make certain deductions from its tier 1 capital related to the value of, or amount paid for, its ownership interests in covered funds.[35]

Under the Proposed Rule, the aggregate limitation on ownership interests in covered funds would not apply with respect to ownership interests held pursuant to the underwriting and market-making exemptions. In addition, no capital deduction would be required with respect to such ownership interests held pursuant to the underwriting and market-making exemptions.[36]

Additional Covered Funds Exemption for Risk-Mitigating Hedging

Under the Current Rule, risk-mitigating hedging activities with respect to ownership interests in a covered fund are permissible only if they meet certain conditions and are "designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee of the banking entity or an affiliate thereof that directly provides investment advisory, commodity trading advisory or other services to the covered fund."[37] Under the Proposed Rule, risk-mitigating hedging activities with respect to ownership interests in a covered fund would also be permissible in connection with "[a] position taken by the banking entity when acting as 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."[38]

CEO Certification for Prime Brokerage Exemption to Super 23A Provisions

The Proposed Rule would incorporate clarifications provided by the FAQs with respect to the CEO certification requirement included in the prime brokerage exemption from the Super 23A restrictions.[39] Reliance on the prime brokerage exemption now requires that the CEO of a banking entity provide a certification that the banking entity does not guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which the covered fund invests.[40] Consistent with the FAQs, the Proposed Rule would clarify that such certification will be required annually no later than March 31 each year, and the CEO would be required to update the certification with respect to any material changes.[41]

PROPOSED CHANGES AFFECTING FOREIGN BANKING ENTITIES

The Proposed Rule would make several important revisions concerning the application of the Volcker Rule to foreign banking entities, *i.e.*, banking entities located outside the United States.

Trading and Covered Funds Activities Outside the United States

The Volcker Rule contains exemptions for activities conducted by foreign banking entities solely outside the United States. The Proposed Rule would expand these exemptions in a manner designed to increase their utility for foreign banking entities. The changes focus on whether the risk inherent in the activity is located or held outside of the United States.

Exemption for Trading Outside the United States

The Current Rule provides an exemption from the proprietary trading restrictions for trading by a foreign banking entity outside the United States (the so-called "TOTUS exemption"). To rely on the TOTUS exemption, the Current Rule requires, among other things, that any employees of the foreign banking entity or its affiliate that

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arrange, negotiate, or execute the trade outside the United States not be located in the United States. The Proposed Rule would relax the exemption by prohibiting only those involved in the decision to make the trade from being located in the United States.

Second, the Proposed Rule would eliminate the Current Rule's requirement for the availability of the TOTUS exemption that no financing for the purchase, sale, or investment be provided by any branch or affiliate of the foreign banking entity located in the United States.

Third, the Proposed Rule would eliminate the requirement that the transaction pursuant to the TOTUS exemption not be conducted with or through a U.S. counterparty.

Exemption for Covered Funds Solely Outside the United States

Under the Current Rule, certain covered fund activity involving a foreign banking entity is permissible if it meets the requirements of the exemption for covered fund activity that occurs solely outside the United States (the so-called "SOTUS covered fund exemption"). The Proposed Rule would eliminate one such requirement – *i.e.*, that no financing for the ownership or sponsorship of the covered fund be provided by a branch or affiliate of the foreign banking entity located or organized under the laws of the United States.

The SOTUS covered fund exemption now requires that "no ownership interest in the covered fund may be offered for sale or sold to a resident of the United States."[42] Consistent with clarification provided in FAQ No. 13, the Proposed Rule would enable foreign banking entities to rely on the SOTUS covered fund exemption for foreign funds that are marketed to residents of the United States if the foreign banking entity does not participate in the marketing. Again, consistent with FAQ No. 13, a foreign banking entity will be deemed to participate in the offering or marketing of ownership interests in covered funds to U.S. residents if the foreign banking entity or its affiliate serves as the covered fund's sponsor, investment manager, investment adviser, commodity pool operator, or commodity trading adviser.

Expansion of Market Risk Capital Rule Test to Cover FBOs

Under the Current Rule, the Market Risk Capital Rule Test applies only if the banking entity or its affiliate is subject to the U.S. market risk capital rules. FBOs are not subject to these rules, and thus are not subject to the Market Risk Capital Rule Test. The Proposed Rule would extend the Market Risk Capital Rule Test to those FBOs "that are subject to capital requirements under a market risk framework established by the home-country supervisor that is consistent with the market risk framework published by the Basel Committee on Banking Supervision."[43]

Extension of No-Action Relief for Foreign Excluded Funds

A "foreign excluded fund" is generally understood to be a fund: (i) in which a foreign banking entity invests or that it sponsors; (ii) that is organized under the laws of a foreign jurisdiction; (iii) the ownership interests of which are offered and sold solely outside the United States; and (iv) that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in financial instruments for resale or other disposition or otherwise trading in financial instruments. Foreign excluded funds are not "covered funds" under the Current Rule.

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Under the Current Rule, the definition of a "banking entity" includes any affiliate of a banking entity but excludes "covered funds." Covered funds controlled by a banking entity, even though they are affiliates of the banking entity, are not themselves banking entities by virtue of the exclusion. However, since foreign excluded funds are not covered funds, they cannot avail themselves of the exclusion from the definition of banking entity. Therefore, if a foreign excluded fund is controlled by a banking entity (through sponsorship or other means), then it will be deemed to be a banking entity and subject to the prohibitions of the Volcker Rule.

On July 21, 2017, the Banking Agencies[44] announced that they would not enforce the prohibitions and restrictions of the Volcker Rule with respect to the activities of certain "qualifying foreign excluded funds" controlled by "foreign banking entities" (as such terms are defined) for a one-year period through July 21, 2018.[45] This no-action relief was extended in the preamble to the Proposed Rule for an additional period until July 21, 2019 to allow the Agencies time to review comments on the Proposed Rule.

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[1] The Proposed Rule has not yet been published in the *Federal Register*. Comments on the Proposed Rule are due 60 days after publication in the *Federal Register*. Citations to the Proposed Rule and the preamble to the Proposed Rule are to the Proposed Rule as released by the Federal Reserve, *available at*: https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180530a1.pdf.

[2] The Agencies responsible for issuing rules to implement the Volcker Rule are the Federal Reserve, the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the U.S. Securities and Exchange Commission, and the U.S. Commodity Futures Trading Commission. All references to the rules implementing the Volcker Rule are to those codified in the Federal Reserve's regulations at 12 C.F.R. Part 248.

[3] A banking entity includes (subject to exceptions) the following: (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 a banking entity. 12 C.F.R. § 248.2(c).

[4] Volcker Rule: FAQs, *available at*: https://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm. Note, the preamble to the Proposed Rule specifically notes that the Proposed Rule would not modify the application of the FAQs.

[5] For more information regarding the statutory changes made to the Volcker Rule by S. 2155, as well as the other reforms enacted by S. 2155, please see our Client Alert, *available at*: https://media2.mofo.com/documents/180522-financial-regulatory-reform.pdf.

[6] An FBO includes a foreign bank (and its parent company) that operates a branch, agency, or commercial lending company subsidiary in the United States; controls a bank in the United States; or controls an Edge corporation acquired after March 5, 1987. *See* 12 C.F.R. § 211.21(o).

[7] 12 C.F.R. § 248.20(a)-(b).

[8] 12 C.F.R. § 248.20(c).

[9] Appendix A to 12 C.F.R. Part 248.

[10] The Propose Rule contains various amendments to the metrics reporting requirements that are not detailed in this Client Alert.

[11] 12 C.F.R. § 248.20(e).

[12] The Proposed Rule would make additional changes to the underwriting exemption from the prohibition on proprietary trading that apply to all banking entities regardless of their level of trading assets and liabilities, which are detailed elsewhere in this Client Alert.

[13] 12 C.F.R. § 248.4(a)(2)(iii).

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[14] The Proposed Rule would make additional changes to the market-making exemption from the prohibition on proprietary trading that apply to all banking entities regardless of their level of trading assets and liabilities, which are detailed elsewhere in this Client Alert.

[15] 12 C.F.R. § 248.4(b)(2)(iii).

[16] 12 C.F.R. § 248.5(b)(1).

[17] 12 C.F.R. § 248.5(b)(2)(i).

[18] 12 C.F.R. § 248.5(b)(2)(ii).

[19] 12 C.F.R. § 248.5(b)(2)(iv)(B).

[20] 12 C.F.R. § 248.5(b)(2)(iv).

[21] 12 C.F.R. § 248.5(b)(2)(iv)(C).

[22] 12 C.F.R. § 248.5(c).

[23] 12 C.F.R. § 248.5(b)(1)(iii).

[24] 12 C.F.R. § 248.5(b)(3).

[25] 12 C.F.R. § 248.3(a) (emphasis added).

[26] Changes to the Market Risk Capital Rule Test with respect to FBOs are detailed elsewhere in this Client Alert.

[27] 12 C.F.R. § 248.3(b)(2).

[28] 12 C.F.R. § 248.3(b)(i).

[29] Proposed Rule §_.3(b)(3).

[30] Preamble to the Proposed Rule at 61.

[31] Preamble to the Proposed Rule at 26-27.

[32] Preamble to the Proposed Rule at 92, 107.

[33] 12 C.F.R. § 248.11(c)(1).

[34] 12 C.F.R. § 248.12(a)(1)(iii).

[35] 12 C.F.R. § 248.12(d). A foreign banking entity that makes a covered fund investment in the United States is not required to deduct the aggregate value of the investment from its tier 1 capital. 79 Fed. Reg. 5731.

[36] The per-fund and aggregate limitations, as well as the capital deduction requirement, would still apply with respect to ownership interests held in covered funds pursuant to two other exemptions: (i) an exemption for organizing and offering covered funds for the purpose of providing bona fide trust, fiduciary, investment advisory, or commodity trading advisory services; and (ii) an exemption for organizing and offering an issuing entity of asset-backed securities. Such limitations would not apply, however, with respect to banking entities that, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of a covered fund or of any covered fund in which such fund invests.

[37] 12 C.F.R. § 248.13(a)(1).

[38] Proposed Rule §_.13(a)(1)(ii).

[39] Subject to exemptions, section 14(a) of the Current Rule prohibits banking entities that: (i) advise or sponsor a covered fund; (ii) organize and offer a customer fund or an issuer of asset-backed securities ("ABS"); or (iii) hold an interest in an ABS issuer, and any of the banking entity's affiliates, from entering into covered transactions, as defined in Section 23A of the Federal Reserve Act, with such funds. This is referred to as the "Super 23A" restrictions because, unlike Section 23A itself, which allows affiliated transactions within limits, the prohibitions here are absolute.

[40] 12 C.F.R. 248.14(a)(2)(ii).

[41] *See* FAQ No. 18.

[42] 12 C.F.R. 248.13(b)(1)(iii).

[43] Proposed Rule §_.3(b)(1)(ii).

[44] The Banking Agencies include the Federal Reserve, OCC and FDIC.

[45] For more information regarding this no-action relief, please see our Client Alert: https://media2.mofo.com/documents/170724-federal-agencies-foreign-funds-volcker.pdf.

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