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Memorandum

Federal Agencies Release Proposed Changes to Volcker Rule

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The five federal financial regulators responsible for implementing the Volcker Rule recently released a joint notice of proposed rulemaking (the "Proposal") that contains a number of proposed revisions to the Volcker Rule's 2013 implementing regulations (the "2013 Rule"). The Proposal generally seeks to clarify certain definitions, exemptions and compliance requirements under the 2013 Rule, and to tailor compliance requirements to be commensurate with a banking entity's level of trading activity. Several aspects of the Proposal relate to recommendations contained in the U.S. Treasury Department's report titled *A Financial System That Creates Economic Opportunities: Banks and Credit Unions* released in June 2017 (the "Treasury Report"). However, as discussed further below, the Proposal would not implement certain key recommendations of the Treasury Report.

The release of the Proposal follows the May 24 enactment of the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Reform Act"), which amended the Volcker Rule to exempt any banking entity (including any company that controls the banking entity) with (1) less than $10 billion in total consolidated assets, and (2) total trading assets and trading liabilities that are not more than 5% of its total consolidated assets. The Reform Act also loosened the restrictions related to the naming of covered funds. The Proposal does not include any changes to implement these statutory amendments, which the agencies plan to address through a separate rulemaking. However, the agencies indicated that they will not enforce the 2013 Rule in a manner inconsistent with the Reform Act's statutory amendments.

Following is a high-level summary of certain key features of the Proposal.

Proprietary Trading Restrictions

"Trading Account" Definition

Under the Volcker Rule's proprietary trading prohibition, banking entities generally may not engage as principal for the "trading account" of the banking entity in any purchase or sale of certain financial instruments. The 2013 Rule defines "trading account" to include three prongs: a "short-term intent prong," a "market risk capital prong," and a "dealer prong." While the Proposal would amend both the "short-term intent prong" and the "market risk capital prong," the "dealer prong" (covering the purchase or sale of positions by a banking entity that is licensed or registered as a dealer, swap dealer or security-based swap dealer with respect to the transaction) would remain unchanged.

1. Short-Term Intent Prong

Under the 2013 Rule's "short-term intent prong," the "trading account" includes any account that is used by a banking entity to purchase or sell financial instruments principally for the purpose of (i) short-term resale, (ii) benefitting from short-term price movements, (iii) realizing short-term arbitrage profits, or (iv) hedging another trading account position covered by the "short-term intent prong."

The Proposal replaces this "short-term intent prong" with a prong tied to the accounting treatment of a position. Under the proposed accounting prong, a "trading account" would include any account used by a banking entity to purchase or sell one or more financial instruments that are recorded at fair value on a recurring basis under applicable accounting standards (*e.g.*, derivatives, trading securities and available-for-sale securities). A trading desk whose entire portfolio is included in the banking entity's "trading account" solely due to this accounting prong would be presumed to be in compliance with the Volcker Rule's prohibition on proprietary trading if the sum of the absolute values of the daily net realized and unrealized gains or losses on its portfolio for the preceding 90-day period does not exceed $25 million.

The Proposal would also remove the rebuttable presumption in the 2013 Rule under which a purchase or sale of a financial instrument is presumed to be for the "trading account" if the banking entity holds the financial instrument for fewer than 60 days or substantially transfers the risk of the financial instrument within 60 days of purchase or sale. The Proposal's elimination of the "short-term intent prong" and the 60-day rebuttable presumption is consistent with the Treasury Report's recommendations.

2. Market Risk Capital Prong

The current definition of "trading account" also includes any account used by a banking entity to purchase or sell one or more financial instruments that are both market risk capital rule covered positions and trading positions (or hedges of other market risk capital rule covered positions), if the banking entity, or any affiliate of the banking entity, is an insured depository institution, bank holding company, or savings and loan holding company, and calculates risk-based capital ratios under the market risk capital rule.

The Proposal would modify this "market risk capital prong" to include, with respect to a foreign banking organization ("FBO"), any account used to purchase or sell financial instruments that are subject to capital requirements under a market risk framework established by the FBO's home-country supervisor that is consistent with the market risk framework published by the Basel Committee on Banking Supervision.

3. Reservation of Authority

Under the Proposal, the agencies would reserve authority to determine, on a case-by-case basis, that any purchase or sale of one or more financial instruments by a banking entity either is or is not for the "trading account" of the banking entity. The agencies indicated that in making such a determination, they would consider the activity's consistency with the Volcker Rule's statutory definition of "trading account," and may consider the impact of the activity on the safety and soundness of the banking entity or the financial stability of the United States, the risk characteristics of the particular activity, or any other relevant factor. The agencies proposed to administer this reservation of authority with notice and response procedures.

Exclusions and Exemptions From the Proprietary Trading Prohibition

The 2013 Rule contains various exclusions and exemptions from the scope of prohibited proprietary trading. The Proposal would modify several of these exclusions and exemptions. However, the Proposal would not implement the Treasury Report's recommendation to exempt from the Volker Rule's proprietary trading prohibition banking entities with less than $1 billion in trading assets and trading liabilities and whose trading assets and trading liabilities represent 10% or less of total assets.

1. Liquidity Management Exclusion

The 2013 Rule excludes from the definition of proprietary trading the purchase or sale of securities for the purpose of liquidity management in accordance with a documented liquidity management plan that meets certain requirements set forth in the rule. However, this liquidity management exclusion is currently limited to the purchase or sale of a *security*, and does not extend to foreign exchange derivative transactions used by a banking entity for liquidity management. The Proposal would amend this liquidity management exclusion to permit foreign exchange forwards, foreign exchange swaps and physically-settled cross-currency swaps used by a banking entity in accordance with a documented liquidity management plan as part of the banking entity's liquidity management activities.

2. Error Trades and Corrections Exclusion

The Proposal would add an exclusion to the 2013 Rule's definition of proprietary trading for transactions in which a banking entity erroneously executes a purchase or sale of a financial instrument in the course of conducting a permitted or excluded activity. This exclusion would also cover any subsequent transactions in which the banking entity engages as principal to correct such errors, including transactions of the banking entity to fulfill its obligation to deliver the financial instrument originally ordered by a customer and to eliminate any principal exposure that the banking entity acquired in the course of its effort to deliver on the customer's original order. A banking entity would be required under the Proposal to transfer any financial instrument purchased in error into a separately-managed trade error account for disposition.

3. Underwriting and Market-Making Exemptions

The 2013 Rule exempts certain underwriting and market-making transactions from the prohibition on proprietary trading that are designed not to exceed reasonably expected near-term demand ("RENTD") of clients, customers or counterparties. The Proposal would establish a rebuttable presumption that a banking entity's trading activity does not exceed RENTD (both with respect to the underwriting exemption and the market-making exemption) if the trading activity is conducted in accordance with underwriting or market-making internal risk limits (as applicable) for each trading desk that are set in accordance with the Proposal. The Proposal would also amend the 2013 Rule so that only a banking entity with $10 billion or more of consolidated gross trading assets and liabilities would be required to have a comprehensive internal compliance program to rely on the underwriting and market-making exemptions.

While the Proposal is generally consistent with the Treasury Report's recommendation to give banks more flexibility in determining the amount of market-making inventory necessary to meet RENTD, it would not directly adopt the Treasury Report's specific RENTD reform recommendations with respect to illiquid securities, over-the-counter derivatives and block trades. In addition, the Proposal would not adopt the RENTD "opt-out" features suggested by the Treasury Report, including exempting a banking entity from the RENTD requirement if it implements narrowly tailored trader mandates that ensure that its activities constitute market making, or exempting a banking entity's transactions in a particular financial instrument if the banking entity fully hedges all significant risks arising from its inventory of that instrument.

4. Risk-Mitigating Hedging Exemption

The 2013 Rule exempts from the prohibition on proprietary trading certain risk-mitigating hedging activities that are designed to reduce the specific risks to a banking entity in connection with or related to individual or aggregated positions, contracts, or other holdings. The Proposal would remove the requirements in the 2013 Rule that a banking entity relying on the risk-mitigating hedging exemption must perform correlation analysis and show that the risk-mitigating hedging activity demonstrably reduces or otherwise significantly mitigates the specific risks being hedged. The Proposal would also eliminate certain compliance program requirements, compensation restrictions and documentation requirements for the activities of a banking entity with consolidated gross trading assets and liabilities of less than $10 billion to qualify for the risk-mitigating hedging exemption. The Proposal would also reduce the documentation requirements associated with certain risk-mitigating hedging transactions.

These proposed changes are consistent with the Treasury Report's recommendation that policymakers reduce the burden on banking entities with respect to hedging business risks. The Proposal would not, however, adopt the Treasury Report's recommendations to eliminate both the requirement to maintain documentation of the specific assets and risks being hedged and the requirement to maintain ongoing calibration of a hedge over time to ensure that it meets regulatory requirements.

5. Permitted Trading Activities of a Foreign Banking Entity

The 2013 Rule permits certain foreign banking entities, subject to several conditions set forth in the rule, to engage in proprietary trading outside of the United States. The Proposal would remove the condition in the 2013 Rule that no personnel of the foreign banking entity that arrange, negotiate, or execute the purchase or sale be located in the United States. The Proposal would also eliminate the condition that no financing for the foreign banking entity's purchase or sale be provided by any branch or affiliate of the banking entity that is located in the United States or organized under the laws of the United States or of any state, and the condition that the purchase or sale not be conducted with or through any U.S. entity.

Covered Fund Activities and Investments

The Proposal contains various changes to, and solicits comments on a number of topics regarding, the provisions of the 2013 Rule relating to covered fund activities and investments. However, the Proposal would not implement the Treasury Report's recommendation to extend the initial "seeding period" exemption from the covered fund investment restriction from one to three years.

1. Definition of "Covered Fund"

The 2013 Rule defines a "covered fund" to mean an issuer that would be any investment company but for sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940, certain commodity pools, and certain foreign funds, and includes a series of exclusions for certain types of issuers from the definition. The Proposal would not change the definition of "covered fund." However, the agencies are seeking comment on whether the current "covered fund" definition is appropriately tailored to identify the hedge funds and private equity funds intended to be covered by the Volcker Rule. In particular, the agencies are seeking comment on whether to separately define "hedge fund" and "private equity fund," and whether to modify existing exclusions (such as those related to foreign public funds, joint ventures and securitizations) or add new exclusions (such as for family wealth management vehicles) to the definition of "covered fund" to more effectively tailor the definition.

The agencies are also seeking comment on whether to adopt a fund characteristics-based approach—the approach recommended by the Treasury Report—which would exclude from the definition of "covered fund" entities that lack certain characteristics commonly associated with hedge funds or private equity funds.

2. Underwriting and Market Making for Third-Party Covered Funds

The 2013 Rule provides that the prohibition on ownership or sponsorship of a covered fund does not apply to a banking entity's underwriting and market making-related activities involving a covered fund so long as certain requirements are met, including that the banking entity count its ownership interest in such covered fund toward its aggregate fund investment limit, its per-fund investment limit and its Tier 1 capital deduction. The Proposal would eliminate the requirement that a banking entity include in its aggregate fund investment limit and Tier 1 capital deduction the value of any ownership interests in a covered fund acquired or retained under the underwriting or market making-related activities exemptions, so long as the banking entity does not sponsor or advise that covered fund.

3. Risk-Mitigating Hedging Activities

The Proposal would expand the scope of risk-mitigating hedging activities involving ownership interests in covered funds permitted for banking entities. Under the 2013 Rule, banking entities are permitted to engage in only limited risk-mitigating hedging activities involving ownership interests in a covered fund in connection with hedging employee compensation arrangements (i.e., where the ownership interest in the covered fund hedges risks to the banking entity in connection with a compensation arrangement with an employee who directly provides services to the covered fund). The Proposal would allow a banking entity to acquire a covered fund interest as a hedge when acting as an intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund, so long as the activity is designed to mitigate risk.

4. "Super 23A" Limitations on Relationships With a Covered Fund

The Volcker Rule generally prohibits a banking entity from entering into a transaction with a covered fund for which it serves as investment manager, investment adviser, organizer or sponsor if such transaction would be a "covered transaction" for purposes of Section 23A of the Federal Reserve Act. However, the Volcker Rule and the 2013 Rule do not incorporate or reference the exemptions from such affiliate transaction restrictions contained in Section 23A or the Federal Reserve's Regulation W. The agencies are seeking comment on whether to incorporate the exemptions provided in Section 23A and Regulation W into the 2013 Rule's limitations on covered transactions with sponsored, managed or advised covered funds, as recommended by the Treasury Report.

5. Covered Fund Activities of Foreign Banking Entities

The Volcker Rule and the 2013 Rule permit a foreign banking entity to acquire or retain an ownership interest in, or sponsor, a covered fund if those investments and activities occur solely outside of the United States ("SOTUS") and certain other conditions are met. The Proposal would effectively codify the agencies' 2015 guidance that, for purposes of the SOTUS exemption to the Volcker Rule's prohibition on ownership or sponsorship of a covered fund, an ownership interest in a covered fund is not "offered for sale or sold to a resident of the United States" if it is not sold, and has not been sold, pursuant to an offering that targets residents of the United States in which the banking entity relying on the SOTUS exemption (or an affiliate) participates. The Proposal would also eliminate the requirement that no financing be provided by any branch or affiliate located in the United States or organized under the laws of the United States or of any state for a banking entity's ownership or sponsorship of a covered fund in reliance on the SOTUS exemption.

6. Treatment of Regulated Investment Companies and Certain Foreign Funds

The 2013 Rule leaves open the possibility that certain entities excluded from the "covered fund" definition would nonetheless be considered "banking entities" (and therefore subject to the Volcker Rule) based on the interaction between the Volcker Rule's definition of the term "banking entity" and the 2013 Rule's definition of "covered fund." For example, U.S. registered investment companies ("RICs"), foreign public funds ("FPFs"), and foreign excluded funds, which are excluded from the definition of "covered fund," may be considered "banking entities" as a result of a sponsoring banking entity having "control" over such a fund, including through the banking entity's investment during a seeding period, or by virtue of corporate governance structures.

The agencies have issued responses to frequently asked questions regarding the treatment of RICs and FPFs, but have not codified such guidance through rulemaking. The agencies also issued a policy statement in July 2017 indicating that the agencies would stay enforcement actions against qualifying foreign excluded funds, or against foreign banking entities based on attribution of a qualifying foreign excluded fund's activities and investments (in each case if certain criteria were met), until July 2018. In addition, the Treasury Report recommended that certain foreign funds that are exempt from the "covered fund" definition should also be exempt from the "banking entity" definition so as to avoid unreasonable and unnecessary limitations on the foreign funds' activities.

The Proposal would not modify the application of the agency FAQs regarding RICs and FPFs, but the agencies are seeking comment regarding the issues raised by the interaction between the 2013 Rule's definitions of "banking entity" and "covered fund." In addition, the agencies indicated that they will extend the one-year no-action period described in the July 2017 policy statement for certain foreign excluded funds for another year (to July 2019).

Volcker Rule Compliance Regime

The 2013 Rule establishes various levels of compliance program requirements based on the relevant banking entity's consolidated asset size and involvement in covered activities. The Proposal would revise this compliance regime by categorizing banking entities based only the banking entity's trading assets and liabilities (without reference to the banking entity's total asset size). Compliance program requirements for each category would be tailored as follows:

Consolidated Gross Trading Assets & Liabilities	Compliance Program Requirements	CEO Attestation Requirement	Metrics Reporting Requirements	Additional Covered Fund Documentation
$10 Billion or More (“Significant”)	“Six Pillar” Program (Currently applicable to banking entities with $10 billion or more in total consolidated assets)	Yes	Yes	Yes
Between $1 Billion and $10 Billion (“Moderate”)	“Simplified” (Update existing policies and procedures)	Yes	No	No
Less than $1 Billion (“Limited”)	None (Presumed compliant)	No	No	No

The presumption of compliance for banking entities with limited trading assets and liabilities could be rebutted by the relevant agency upon examination or audit, and agencies would have the authority to subject a banking entity with limited or moderate trading activity to the metrics reporting and CEO attestation requirements (to the extent not already subject to such requirements) on a case-by-case basis. Notably, the Proposal would entirely eliminate the “enhanced” compliance program requirements, which are currently applicable to banking entities with over $50 billion in total consolidated assets or significant trading assets and liabilities, consistent with the Treasury Report’s recommendation. In addition, the Proposal would amend the 2013 Rule’s requirements for banking entities to report certain quantitative metrics related to asset classes, markets and trading activities (applicable only to banking entities with significant trading assets and liabilities under the Proposed Rule) to streamline such reporting requirements and reduce compliance-related inefficiencies. The Proposal would not, however, adopt the Treasury Report’s recommendation that all banking entities be given greater ability to tailor their compliance programs to the particular activities engaged in by the banking entity and the particular risk profile of that activity.

The agencies estimate that, as of December 31, 2017, all but approximately 40 top-tier banking entities would be eligible for presumed compliance, accounting for approximately 98% of the total U.S. trading activity by banking entities.

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