

CLIENT ALERT

# U.S. Regulatory Agencies Propose Amendments to Rules Implementing the Volcker Rule

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The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission and the Commodity Futures Trading Commission (collectively, the “**Agencies**”) have proposed amendments to their regulations implementing the Volcker Rule. The proposed amendments are intended to provide greater clarity and certainty to banking entities regarding the scope of the Volcker Rule’s prohibitions and to facilitate compliance. The proposed rules, if adopted, generally would simplify the restrictions imposed by the Volcker Rule on proprietary trading and certain covered fund activities and would permit banking entities to adopt more narrowly tailored compliance programs. The proposal would leave in place the Volcker Rule’s general prohibition on proprietary trading and limitations on activities and investments with respect to covered funds. The preamble includes over 340 questions, many with multiple subparts, on which the Agencies are seeking specific comments. Comments on the proposal are due 60 days following publication of the proposed rules in the Federal Register.<sup>1</sup>

## Background

Section 13 of the Bank Holding Company Act of 1956 (the “**BHCA**”), also known as the “**Volcker Rule**,” generally prohibits a banking entity from engaging as principal in the purchase and sale of financial instruments for the purpose of

<sup>1</sup> Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, \_\_ Fed. Reg. \_\_ ( \_\_ 2018).

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profiting from short-term price movements and from acquiring or retaining an ownership interest in or sponsoring a private equity or hedge fund (“**Covered Fund**”), in each case subject to certain enumerated exemptions. The Volcker Rule was added to the BHCA as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.<sup>2</sup> In December 2013, the Agencies issued final rules implementing the provisions of the Volcker Rule (the “**2013 Rules**”).<sup>3</sup>

The Volcker Rule, as implemented by the 2013 Rules, generally also requires banking entities to develop and administer a compliance program reasonably designed to ensure compliance with the Volcker Rule, and to satisfy certain recordkeeping and reporting requirements.

### Proposed Amendments to 2013 Rules

The Agencies are proposing to amend the 2013 Rules in order to improve implementation of the 2013 Rules and to address concerns regarding ambiguity, overbroad application and burdensome compliance obligations that have been expressed by banking entities since adoption of the 2013 Rules. If adopted as proposed, the rules would potentially simplify and tailor the obligations of banking entities and reduce compliance costs and inefficiencies. The proposed rules would do so, in part, by creating three categories of banking entities based on their level of trading activity. While the proposed rules generally would require banking entities with significant trading assets and liabilities to continue to satisfy heightened compliance requirements, banking entities with less significant trading assets and liabilities would be subject to reduced compliance obligations under the amended rules, and those with only limited trading assets and liabilities would benefit from a presumption of compliance with the provisions of the 2013 Rules relating to proprietary trading and Covered Fund-related activities.

#### 1. Amendments to Proprietary Trading Rules

The 2013 Rules define proprietary trading as engaging as a principal for the trading account of a banking entity in any purchase or sale of one or more financial instruments. The Agencies are proposing to amend the definition of “trading account” to increase clarity as to which positions are subject to the Volcker Rule’s restrictions on proprietary trading. Notably, the proposed rules would eliminate the “short-term intent” prong of the definition, which covers any account that is used by a banking entity to purchase or sell a financial instrument 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

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<sup>2</sup> Section 13 of the BHCA was amended on May 24, 2018 by the Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, 132 Stat. 1296-1368, which excepted certain “banking entities” from the Volcker Rule and revised the provisions of the Volcker Rule relating to the naming of Covered Funds. The Agencies have indicated that they intend to address these amendments through a separate rulemaking process.

<sup>3</sup> See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5535 (Jan. 31, 2014) (Federal Reserve Board, FDIC, OCC and SEC final rule); Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5808 (Jan. 31, 2014) (CFTC final rule).

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account position. The proposal would also eliminate the existing rebuttable presumption that the purchase or sale of any position held for fewer than 60 days is for the banking entity's trading account. The proposed rule generally would not alter the other prongs of the trading account definition, except that the market risk capital prong would be modified to cover the trading positions of foreign banking organizations subject to similar requirements in the applicable foreign jurisdiction.

In lieu of the short-term intent prong, the proposed rules would substitute an "accounting" prong, pursuant to which a trading desk that trades a financial instrument recorded at fair value on a recurring basis under applicable accounting standards would be trading such instrument for the banking entity's trading account. The amendment would also introduce a presumption of compliance with the Volcker Rule's proprietary trading restriction, available only in respect of a trading desk that does not purchase or sell financial instruments that are within the scope of the other two prongs of the trading account definition, if the sum of the absolute values of the gains and losses attributable to such trading desk does not exceed a specified threshold over a rolling 90-day period.

The proposed rules, if adopted, would also impact the exemptions from the definition of proprietary trading by making the following changes, among others:

- amending the exclusion for liquidity management activities to permit a banking entity to use foreign exchange forwards, foreign exchange swaps and physically settled cross-currency swaps as part of its liquidity management activities;
- establishing an exemption for trade errors and subsequent correcting transactions;
- modifying the underwriting and market making exemptions by establishing a presumption that a banking entity that trades within internally set risk limits has satisfied the requirement that underwriting or market making activity, as applicable, be designed not to exceed the reasonably expected near-term demand of clients, customers or counterparties; and
- allowing for banking entities to more easily engage in permitted risk-mitigating hedging activities.

### 2. Amendments to Covered Fund Rules

The proposal aims to further refine the implementation of the Volcker Rule's limitations on banking entities' ownership or sponsorship of Covered Funds. The proposed rules would achieve this objective in part by better facilitating permitted underwriting, market making and hedging activities relating to Covered Funds. In addition, in connection with the proposed rules, the Agencies are soliciting comments on a number of topics relating to Covered Funds, including whether the definition of Covered Fund effectively implements the statute and is appropriately tailored. It remains to be seen

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whether further changes may result from the Agencies' review of comments received on the proposal, including with respect to the scope of the existing restrictions on Covered Fund activities.

As noted, the proposal would amend certain aspects of the 2013 Rules as they relate to underwriting and market making of ownership interests in Covered Funds. The 2013 Rules generally permit such activities, provided that a banking entity conducts them in accordance with the requirements applicable to underwriting and market making in other covered financial instruments and complies with certain aggregate and single fund ownership limits. The proposed rules, if adopted, generally would permit a banking entity to exclude, for purposes of the aggregate ownership limit and related capital deduction requirement, the value of such banking entity's ownership interest in a Covered Fund that it has not organized or offered as permitted under the 2013 Rules, to the extent such ownership interest was obtained in connection with the banking entity's underwriting or market making activities. However, the banking entity's underwriting and market making activities would remain subject to the requirement that such entity's exposure be consistent with the reasonably expected near-term demand of its clients, customers and counterparties, among other requirements.

The proposed rules, if adopted, would also expand the scope of permitted risk-mitigating hedging activities in respect of Covered Funds by permitting a banking entity to acquire or retain an ownership interest in a Covered Fund as a risk-mitigating hedge when acting as an intermediary for a non-bank customer to facilitate the exposure by such customer to the economic returns of the Covered Fund. Such activities, if permitted, would be subject to required risk limits and procedures for monitoring exposure. The existing exemption for hedging activities in respect of employee compensation arrangements would remain unchanged.

In connection with the proposed rules, the Agencies are also considering certain changes with respect to foreign public funds, Covered Fund activities occurring outside of the United States and the 2013 Rules' provisions relating to certain transactions with Covered Funds, such as prime brokerage transactions.

### 3. Amendments to Compliance Requirements

As noted above, the 2013 Rules require banking entities to adopt and administer a compliance program reasonably designed to ensure compliance with the Volcker Rule and also impose certain recordkeeping and reporting obligations. For larger banks with more extensive trading activities, Appendix B to the 2013 Rules also establishes certain enhanced minimum standards that must be satisfied. The proposed rules, if adopted, would divide banking entities subject to the 2013 Rules into three categories based on whether a banking entity's level of trading assets and liabilities is "significant," "moderate" or "limited," and would permit the tailoring of such banking entity's compliance obligations accordingly. The proposed rules would also eliminate the enhanced minimum standards under Appendix B, while retaining the existing CEO attestation requirement for certain banking entities.

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Under the proposed rules:

- A banking entity with *significant trading assets and liabilities* would continue to be subject to the six-pillar compliance program requirement currently set forth in the 2013 Rules, along with certain metrics reporting and Covered Fund documentation requirements, in addition to the CEO attestation rule. However, such banking entity would be permitted to tailor its compliance program to reflect the structure and activities of its organization and to build on existing compliance regimes, which may result in decreased costs.
- A banking entity with *moderate trading assets and liabilities* would be subject to reduced compliance obligations commensurate with the size, scope and complexity of its activities. Any such banking entity would generally be required only to include in its existing compliance policies and procedures appropriate references to the requirements of the Volcker Rule and certain provisions of the 2013 Rules, and to satisfy the CEO attestation requirement.
- A banking entity with *limited trading assets and liabilities* would have no ongoing obligation to demonstrate compliance with the provisions of the 2013 Rules relating to proprietary trading or Covered Fund activities. Any such banking entity would, however, remain subject to the statutory prohibitions of the Volcker Rule and would be required to remediate any impermissible activity upon notification by the appropriate Agency.

The Agencies would also retain the authority to require a banking entity with moderate or limited trading assets or liabilities to comply with the more extensive compliance obligations of banking entities with significant trading assets and liabilities under certain circumstances.

Willkie will continue to monitor developments in these rulemaking proceedings and with respect to the Volcker Rule generally.

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