

# A Look At The Proposal to Simplify The Volcker Rule

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On May 30, the Federal Reserve issued a proposal (the “Proposed Regulations”) to revamp regulations implementing the Volcker Rule, a centerpiece of the Dodd-Frank Act. The 373-page proposal, developed jointly with the other federal banking agencies and the Securities and Exchange Commission (“SEC”) and the Commodity Futures Trading Commission (“CFTC”) (collectively, the “Agencies”),<sup>1</sup> comes four and a half years after the original regulations were adopted.

The Proposed Regulations attempt to tailor compliance requirements, with more onerous requirements applying to banking entities with significant trading assets and liabilities, and to streamline and simplify how various exemptions and reporting requirements work. Among other things, the proposal would scrap the 60-day rebuttable presumption for when financial instruments are deemed to be for a banking entity’s trading account, eliminate the “enhanced” standards for compliance programs, expand the scope of the risk-mitigating hedging exemption for covered funds, and make it easier for foreign banking entities to comply with the so-called TOTUS and SOTUS exemptions.

The Agencies are seeking comment on all aspects of the Proposed Regulations and have posed specific questions on an array of topics. The comment period is expected to run at least 60 days.

## I. Tailoring Application by the Size of a Banking

# Entity's Trading Assets and Liabilities

The Proposed Regulations would adopt a tailored approach to the Volcker Rule by imposing only the most comprehensive restrictions on banking entities that have the largest trading activities. In this regard, the Proposed Regulations would create three broad categories of banking entities: (i) those with “significant trading assets and liabilities,” (ii) those with “limited trading assets and liabilities,” and (iii) those with “moderate trading assets and liabilities.”<sup>2</sup>

- **Significant Trading Assets and Liabilities** – Banking entities with “significant trading assets and liabilities” would include those banking entities that have, along with their affiliates, trading assets and liabilities the gross sum of which over the four previous quarters (measured as of the last day of the quarter) equals or exceeds \$10 billion (excluding trading assets and liabilities involving obligations of or guaranteed by the U.S. or a U.S. agency). For top-tier U.S. banking organizations, this calculation would be based on worldwide trading assets and liabilities. For top-tier foreign banking organizations, this calculation would be based on trading assets and liabilities of the combined U.S. operations of the foreign banking organization (including its U.S. branches, agencies, and subsidiaries). According to Federal Reserve staff, 18 banking organizations are believed to fall within this category.
- **Limited Trading Assets and Liabilities** – Banking entities with “limited trading assets and liabilities” would include those banking entities that have, along with their affiliates, trading assets and liabilities the gross sum of which over the four previous quarters (measured as of the last day of the quarter) is less than \$1 billion (excluding trading assets and liabilities involving obligations of or guaranteed by the U.S. or a U.S. agency). For both top-tier U.S. banking organizations and top-tier foreign banking organizations, the calculation would be based on worldwide trading assets and liabilities. Thus, while many U.S. community and regional banks will likely fall into this category, foreign banking organizations operating in the United States typically have worldwide trading assets and liabilities in excess of \$1 billion and may fall outside this category, even if they have no U.S. trading activities.
- **Moderate Trading Assets and Liabilities** – Banking entities with “moderate trading assets and liabilities” would include those banking entities that are subject to the Volcker Rule but have neither “significant trading assets and liabilities” nor “limited trading assets and liabilities.” This category will likely include some regional and super-regional banking organizations as well as many foreign banking organizations operating without large U.S. trading operations.

Banking entities with “***significant trading assets and liabilities***” would remain subject to the full panoply of compliance, metrics reporting, programmatic, and documentation requirements, as well as the CEO attestation requirement, except as otherwise modified by the Proposed Regulations.

The Proposed Regulations tailor the Volcker Rule by reducing the Volcker Rule’s compliance requirements with respect to those banking entities with either “moderate trading assets and liabilities” or “limited trading assets and liabilities.”

Banking entities with **“moderate trading assets and liabilities”** would no longer be subject to:

- *The “six-pillar” compliance program requirements* (instead, banking entities in this category would be permitted to adopt the a “simplified” compliance program, which means that they may incorporate Volcker Rule compliance into existing policies and procedures, rather than on a standalone basis, as appropriate given their activities, size, scope, and complexity).
- *The requirement to maintain specific compliance programs in connection with any underwriting or market-making activities.*
- *The covered fund documentation requirements* (regarding the exclusions or exemptions relied upon by the banking entity when sponsoring a covered fund).
- *Any of the requirements found in the “risk-mitigating hedging” exemption*, other than the requirement that the hedging activity be designed to reduce or otherwise mitigate one or more specific, identifiable risks arising in connection with and related to one or more identified positions, contracts, or other holdings and that the hedging activity be recalibrated to maintain compliance with the Volcker Rule.

Consistent with the existing Volcker Rule regulations, banking entities in this category would continue to be exempt from the metrics reporting requirements. However, the Proposed Regulations would require all banking entities within the “moderate trading assets and liabilities” category to comply with the annual CEO attestation requirement. Previously, this attestation requirement extended only to those banking entities with consolidated assets in excess of \$50 billion. In theory, this change could subject certain smaller banking organization with trading assets and liabilities in excess of \$1 billion to the CEO attestation requirement for the first time.

Banking entities with **“limited trading assets and liabilities”** would be afforded a presumption of compliance with the Volcker Rule regulations “and shall have no obligation to demonstrate compliance with [Volcker] on an ongoing basis.” This would effectively remove from these banking entities all Volcker Rule compliance requirements. However, this presumption can be rebutted if an Agency determines in an examination or audit that the banking entity has engaged in activities prohibited by the Volcker Rule, subject to notice to and response by the banking entity. In this case, the banking entity would be treated as a banking entity with “moderate trading assets and liabilities” and would be required to adopt the appropriate compliance procedures. Thus, banking entities within this category may wish to retain some level of Volcker Rule compliance to prevent a rebuttal of the presumption and a resulting reclassification into the “moderate trading assets and liabilities” category.

## **II. Elimination of “Enhanced” Compliance Program Requirements**

The proposal would eliminate entirely the highly prescriptive “enhanced compliance program” that has been applied to banking entities with more than \$50 billion in total consolidated assets or more than \$10 billion in trading assets and revenues. These program requirements, set forth in Appendix B to the current regulations,

contain hundreds of specific requirements and have been widely criticized as being unnecessarily complex and costly to implement.

### **III. Proprietary Trading**

As widely anticipated, the Proposed Regulations would make a number of changes to the proprietary trading provisions.

#### **A. Elimination of the Intent Prong and Rebuttable Presumption within the “Trading Account” Definition**

The Proposed Regulations would eliminate the so-called “intent” prong of the “trading account” definition, which defined a “trading account” as including an account of the banking entity used for the purpose of purchasing or selling financial instruments by the banking entity if made with certain short-term profit-related intent. The “intent” prong had been widely criticized as highly subjective and impracticable to apply, and was expected to be eliminated in this proposal. The Proposed Regulations would also eliminate the rebuttable presumption that positions held for less than 60 days are deemed to be in a trading account (and, thus, potentially illegal proprietary trading). This rebuttable presumption was also widely criticized because the only means for a banking entity to rebut the presumption was to establish that short-term profit-related intent was not the basis for the transaction, which, as mentioned above, was both subjective and highly impracticable.

#### **B. Retention of the Dealer Prong and the Market Risk Capital Prong within the “Trading Account” Definition**

The Proposed Regulations retain the remaining two prongs of the “trading account” definition: the “dealer” prong and the “market risk capital” prong. The Proposed Regulations leave largely unchanged the “dealer prong,” which deems a transaction in a financial instrument to be in a trading account if conducted by a dealer in its capacity as a dealer. The Proposed Regulations modify the market risk capital prong slightly. Previously, this prong deemed a transaction in a financial instrument to be in a trading account if considered to be a covered position or trading position under the U.S. market risk capital rules. The Proposed Regulations modify this prong to include, with respect to foreign banking organizations, the comparable non-U.S. market risk capital regulations adopted by the foreign banking organization’s home country supervisor. This change is not a surprise and was widely anticipated, if not already implemented, by many foreign banking organizations.

#### **C. Addition of a New “Accounting” Prong within the “Trading Account” Definition**

The Proposed Regulations would add a new “accounting” prong to the “trading account” definition. Under this newly proposed prong, a transaction in a financial instrument would be deemed to be in a “trading account” if that “financial instrument . . . is recorded at fair value on a recurring basis under the applicable accounting standards.” This new prong would enable a banking entity not subject to

the dealer prong or the market risk capital prong to rely on applicable accounting standards (such as GAAP or IFRS) to determine whether a transaction should be deemed in a trading account. Although the term “fair value” is not defined in the Proposed Regulations, the accompanying commentary refers to “fair value” as a measurement basis in accounting and cites the GAAP definition of “fair value” as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

#### **D. Addition of a Limited Presumption of Compliance**

The Proposed Regulations would provide a limited presumption of compliance with the proprietary trading restrictions. The presumption would apply at the trading desk level, and only to those trading desks not covered by the dealer prong (*i.e.*, trading desks of a regulated dealer) or the market risk capital prong (*i.e.*, trading desks of a banking entity large enough to be subjected to market risk capital rules). Thus, the presumption would apply only to those trading desks that engage in transactions that otherwise would be captured solely by the new accounting prong. The presumption of compliance would apply only if the sum of the absolute values of the daily net realized and unrealized gain and loss figures of that trading desk for the prior 90-day calendar period is less than \$25 million. As proposed, a banking entity must promptly notify the appropriate Agency if a trading desk relies on this presumption but exceeds this \$25 million threshold, and then must demonstrate to the Agency that the trading desk’s transactions otherwise comply with the requirements of the Volcker Rule. This affirmative duty to disclose renders this proposed presumption of compliance somewhat unattractive.

#### **E. Expansion of the Liquidity Management Exclusion from Proprietary Trading**

The existing exclusion from proprietary trading for certain liquidity management activities is limited to transactions in securities. The Proposed Regulations would expand this exclusion to include transaction in certain other types of financial instruments, namely, F/X forwards, F/X swaps, and physically settled cross-currency swaps.

#### **F. New Bona Fide Error Exclusion**

The Proposed Regulations would add a new exclusion from proprietary trading for to trades made in error, or for correcting trades, provided that the erroneously purchased (or sold) financial instrument is promptly transferred by the banking entity to a separately managed trade error account for disposition.

#### **G. New Authority for Agency Determinations**

The Proposed Regulations would add new authority for an Agency to determine for itself whether a specific transaction is or is not for the trading account of a banking entity, subject to a written notice to the banking entity a right to respond.

#### **H. Changes to the RENTD Requirements**

The existing regulations permit reliance on the underwriting and market-making exemption only if the amount and type of securities in the banking entity's position are designed not to exceed the "reasonably expected near term demands of customers, clients, or counterparties," a standard known as "RENTD." In connection with the market-making exemption, banking entities are required to support the RENTD analysis with a "demonstrable analysis of historical customer demand, current inventory of financial instruments, and market and other factors." The Proposed Regulations would eliminate this "demonstrable analysis" condition to the market-making exemption.

In addition, the Proposed Regulations would create a limited rebuttable presumption of compliance with the underwriting and market-making RENTD requirements, provided that the banking entity establishes at the trading desk level certain "risk limits." These risk limits must be designed not to exceed the reasonably expected near term demand of clients, customers, and counterparties based on the amount, type, and risk of the position, and other factors. Inasmuch as the risk limits themselves must be developed using a RENTD analysis, it is not entirely clear that the new risk limit concept entails a material change from the existing RENTD requirements, although the Agencies explain that the benefit is that "a banking entity would not be required to adhere to any specific, pre-defined requirements for the limit-setting process beyond the banking entity's own ongoing and internal assessment of the amount of activity that is required to conduct underwriting, including to reflect the banking entity's ongoing and internal RENTD assessment. Risk limits established under this rebuttable presumption would be subject to review by the Agencies, and a banking entity would be required to promptly report any violation by the trading desk of the risk limits to the appropriate Agency, rendering reliance on this rebuttable presumption somewhat unattractive.

## **I. Changes to the Risk-Mitigating Hedging Exemption**

The Proposed Regulations would make a number of changes to the requirements of the risk-mitigating hedging exemption. Banking entities within the "moderate trading assets and liabilities" category would no longer be subject to any requirements of this exemption other than the requirement that, at the inception of the hedge, the risk-mitigating hedging activity is designed to reduce or significantly mitigate one or more specific risks, and the hedge is subject to periodic ongoing recalibration.

While banking entities with significant trading assets and liabilities would remain subject to the existing conditions of the exemption, the Proposed Regulations would modify those conditions by removing the requirements (i) that the hedge be shown to have in fact demonstrably reduced or otherwise significantly mitigated an existing risk, and (ii) that the banking entity engage in correlation analysis and ongoing independent testing to ensure that such demonstrable reduction or significant mitigation has occurred.

The Proposed Regulations also would create a limited exception from the special documentation requirements applicable to cross-desk hedging transactions. This would exclude from the documentation requirements a banking entity's hedging activity conducted through the purchase or sale of financial instruments appearing

on a written list of pre-approved financial instruments that are commonly used by the trading desk for specific types of hedging, and the banking entity has established pre-approved hedging limits for trading in these types of instruments by the trading desk.

## **J. Quantitative Metrics for Trading Activities**

With respect to metrics reporting, the Agencies are proposing several changes, including limiting the applicability of certain metrics only to market-making and underwriting desks, replacing the Customer-Facing Trade Ratio with a new Transaction Volumes metric, replacing Inventory Turnover with a new Positions metric, and eliminating inventory aging data for derivatives.

## **IV. Covered Fund Activities**

The Proposed Regulations make relatively limited changes to the covered fund provisions and no changes to the “covered fund” definition itself. Among the more important changes is the expanded risk-mitigating hedging exemption, as discussed below.

### **A. The “Banking Entity” Definitional Dilemma Continues for Now**

Under the existing Volcker Rule regulations, the term “banking entity” is defined to exclude any “covered fund” under the Volcker Rule, but any fund that is *not* a covered fund generally falls within the “banking entity” definition if it is affiliated with a banking entity. This distinction has produced a number of unintended compliance and other challenges for such funds, particularly for U.S. registered investment companies (“RICs”), foreign public funds, and offshore funds (commonly referred to as “foreign excluded funds”). In certain circumstances, these funds are deemed to be “banking entities” and are themselves required to comply with the Volcker Rule. However, the proposal offers no fix here. Instead, existing FAQs addressing the treatment of RICs and foreign public funds will remain in place. As for foreign excluded funds, the Agencies are extending, by another year, the no-action relief for those funds that meet the qualifying criteria set forth in their policy statement of July 21, 2017. The policy statement announced that the Agencies would not take action for one year against a foreign banking entity based on attribution of the activities and investments of a qualifying foreign excluded fund. This no-action relief has been extended through July 21, 2019.

### **B. Expanded Risk-Mitigating Hedging Exemption**

The Proposed Regulations would restore an exemption found in the original 2011 proposed regulation allowing a banking entity to acquire a covered fund ownership interest as a risk-mitigating hedge against customer exposures. Like the 2011 proposal, the Proposed Regulations would require that the ownership interest in the covered fund be “taken by the banking entity [only] 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.” The proposed

restoration of this exemption would permit banking entities to resume offering certain fund-linked programs. In the commentary accompanying the existing regulations, it was reasoned that such programs entailed “high-risk trading strategies” even where the banking entity was fully hedged and the only risk to the banking entity was counterparty credit risk. The Agencies appear to have conceded that such programs do not necessarily pose high risk from a Volcker perspective.

## **C. Revised Underwriting and Market-Making Exemption**

The Proposed Regulations largely retain the existing exemption for underwriting and market-making related activities for ownership interests in covered funds. However, in the case of covered funds that the banking entity does *not* organize and sponsor, a banking entity no longer would need to include in its aggregate fund limit and capital deduction the value of any ownership interests of the covered fund acquired or retained under the exemption.

## **D. Super 23A and the Potential Incorporation of Section 23A Exemptions**

The so-called “Super 23A” provision under Volcker flatly prohibits a banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a covered fund from entering into any “covered transaction,” as defined under Section 23A of the Federal Reserve Act, with the fund or any other covered fund that is controlled by such fund. However, existing regulations under Volcker do not incorporate any of the exemptions contained in Section 23A of the Federal Reserve Act or the Federal Reserve’s Regulation W. The proposal solicits comment on whether the Agencies should incorporate these exemptions into Super 23A.

The Proposed Regulations also address futures commission merchant (“FCM”) clearing services. In 2017, the CFTC issued a letter to an FCM stating that no enforcement would be recommended against an FCM under the Volcker Rule as a result of futures, options, and swaps clearing services being provided by a registered FCM to covered funds for which affiliates of the FCM are providing investment management services. In the proposal, the other Agencies confirm their non-objection to the CFTC’s relief and acknowledge that providing such clearing services to customers of affiliates does not appear to be the type of relationship that was intended to be limited under the Volcker Rule.

## **V. Relief for Foreign Banks**

Foreign banks will welcome several key changes to the so-called TOTUS and SOTUS exemptions. These exemptions permit foreign banking organization to engage in proprietary trading and covered fund activities outside the United States, provided certain conditions are met.

### **A. TOTUS Exemption for Proprietary Trading Activities**

The Volcker Rule’s “trading outside the United States,” or “TOTUS,” exemption would

be modified in a number of important respects.

First, the Proposed Regulations would remove the prohibition on financing for a banking entity's purchase or sale being provided by any branch, agency, or affiliate that is located in the United States or organized under the laws of the United States or of any state. This restriction was removed due to concerns regarding fungibility of money and the inability of banking entities to prove the source of financing came from outside the United States, as well as the recognition that financing results in credit risk, which is not the type of risk intended to be addressed by the Volcker Rule.

Second, the Proposed Regulations would modify the current requirement that no personnel of the banking entity or its affiliate that arrange, negotiate, or execute the trade be located in the United States. Instead, the Proposed Regulations would require that "the banking entity (including relevant personnel) that makes the decision to purchase or sell as principal is not located in the United States or organized under the laws of the United States or of any State." According to the Agencies, this change recognizes that "some limited involvement by U.S. personnel" in the arranging or negotiating of the transaction "would be consistent with this exemption so long as the principal bearing the risk of a purchase or sale is outside the United States."

And third, the Proposed Regulations would remove entirely the condition to the TOTUS exemption that the purchase or sale not be "with or through" a U.S. entity (other than an unaffiliated market intermediary). This change will permit foreign banking organizations to use their U.S. affiliates to broker and clear TOTUS transactions.

## **B. SOTUS Exemption for Covered Fund Activities**

The Volcker Rule's "solely outside the United States," or "SOTUS," exemption would be modified by removing the financing prohibition (*i.e.*, the requirement that no financing for the banking entity's ownership or sponsorship is provided by any branch, agency, or affiliate that is located in the United States or organized under the laws of the United States or of any state).

In addition, the Proposed Regulations would codify the Agencies' FAQ 13 issued in 2015 regarding the SOTUS exemption's requirement that no ownership interest in the covered fund be offered for sale or sold to a U.S. resident. In this regard, the Proposed Regulations would clarify that an ownership interest in a covered fund is not considered to be offered for sale or sold to a U.S. resident for purposes of the SOTUS exemption unless sold in an offering that targets U.S. residents in which the banking entity or any affiliate participates. Otherwise, a foreign banking organization would be permitted to acquire an ownership interest in a covered fund open to investment by U.S. residents. For this purpose, the Proposed Regulations provide that (as in FAQ 13), if the banking entity or an affiliate sponsors or serves as the investment manager, investment adviser, commodity pool operator, or commodity trading advisor to the covered fund, then the banking entity will be deemed to have participated in the offer or sale of ownership interests in the covered.

## VI. Areas for Public Comment

The proposal asks 342 specific questions covering nearly every aspect of the Volcker Rule. Many questions center on whether certain definitions or exemptions are too narrow or too broad, whether proposed alternatives are more effective in implementing the statute, and whether parts of the proposal could be made clearer.

Below is a selection of some of the more significant questions that have been posed:

### General Conceptual Issues on Covered Funds

- Should revised regulations use and have separate definitions for “hedge fund” and “private equity” instead of a unified “covered fund” definition?
- Should revised regulations take a “characteristics-based” approach to defining a “covered fund,” such that issuers that currently rely on Section 3(c)(1) (100 or fewer holders) or Section 3(c)(7) (qualified purchasers) of the Investment Company Act of 1940 will not be covered funds in the first instance *unless* they have characteristics or traits commonly associated with hedge funds or private equity funds?
- Is it appropriate to exclude from the “covered fund” definition any entity that does not meet either of the SEC’s Form PF definitions of “hedge fund” or private equity fund”?
- Are there certain types of funds picked up in the existing definition that do not engage in investment activities contemplated by the Volcker Rule?

### Foreign Public Funds, Family Wealth Management Vehicles, and Joint Ventures

- Is the existing exclusion for foreign public funds appropriate or adequate?
- Should family wealth management vehicles be specifically excluded from the “covered fund” definition, how should such vehicles be defined, and could an exclusion create any opportunities for evading compliance with the Volcker Rule?
- Should the existing exclusion for joint ventures be modified and has its utility been affected by the FAQ discussing the extent to which an excluded joint venture may invest in securities?

### Securitizations

- Are there any concerns about how the existing exclusions from the “covered fund” definition for securitizations, qualifying asset-backed commercial paper conduits, and qualifying covered funds work in practice?
- Should the Agencies expand the loan securitization exclusion to permit an issuing entity to hold a broader array of assets than those listed in the existing rule, such as allowing a loan securitization vehicle to hold up to 5% or 10% of its assets in debt securities rather than loans?
- Should the Agencies modify the loan securitization exclusion to reflect the views of Agency staffs’ in response to a FAQ that servicing assets may be any type of asset, provided that any servicing asset that is a security must be a permitted security under the existing regulations?
- Should the definition of “ownership interest” in the context of securitizations be modified?

### Tender Option Bonds (“TOBs”)

- Should TOB vehicles sponsored by banking entities be viewed differently than other types of covered funds sponsored by banking entities?

### Employees’ Securities Companies (“ESCs”)

- Should an ESC still be treated as a banking entity if its banking entity sponsor controls the ESC by virtue of corporate governance arrangements (which is a required condition of SEC exemptive relief)?

### Loan-Related Swaps

- How should loan-related swaps be defined?
- Is it appropriate to treat loan-related swaps as permissible under the market-making exemption if a banking entity stands ready to enter into such swaps upon request by a customer, but enters into such swaps on an infrequent basis due to the nature of the demand for such swaps?

### Affiliated Units

- What are the circumstances in which an organizational unit of an affiliate of a trading desk engaged in market-making related activities would be permitted to enter into a transaction with the desk in reliance on the market-making risk management exemption available to the desk?

### Trading Activities

- Should banking entities be able to engage in hedging transactions directly related to market making positions, including multi-desk market making hedging, regardless of which desk undertakes the hedging trades?
- Should banking entities be able to include affiliate hedging transactions in RENTD determinations and in establishing internal risk limits?

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1 These existing regulations are codified at 12 C.F.R. Part 248 (Federal Reserve), 12 C.F.R. Part 44 (OCC), 12 C.F.R. Part 351 (FDIC), 17 C.F.R. Part 255 (SEC), and 17 C.F.R. Part 75 (CFTC).

2 As discussed in our Clients & Friends Memo dated May 25, 2018, the recently enacted Economic Growth, Regulatory Reform, and Consumer Protection Act (Pub. Law No. 115-174) exempts from the Volcker Rule an insured depository institution that does not have and is not controlled by a company that has (i) more than \$10 billion in total consolidated assets and (ii) total trading assets and trading liabilities that are more than 5% of total consolidated assets. This statutory amendment has already removed many community banks (and their affiliates) from the entirety of the Volcker Rule.

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