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Financial Regulators Issue Proposed Rulemaking Revising Volcker Rule Restrictions and Compliance Requirements

JUNE 13, 2018

The Board of Governors of the Federal Reserve System (FRB) unveiled a Notice of Proposed Rulemaking (NPRM) seeking comment on proposed revisions to the regulations implementing Section 13 of the Bank Holding Company Act, commonly known as the Volcker Rule. The Office of the Comptroller of the Currency (OCC), the Commodity Futures Trading Commission (CFTC) and the Federal Deposit Insurance Corporation (FDIC) followed suit over the next several days, and on June 5 the Securities and Exchange Commission (SEC) became the final banking agency to advance the proposal (collectively, the Agencies).[1]

Enacted in the wake of the 2008 financial crisis as part of the Dodd-Frank Act reforms, the Volcker Rule was intended to reduce risk to the US financial system by prohibiting banks from engaging in proprietary trading or from owning hedge funds and private equity funds, subject to certain exclusions and exceptions. The rule covers a variety of banking entities, including (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 any of the aforementioned entities, such as a broker-dealer (collectively, banks).[2]

Since its implementation, however, banks, industry and trade groups, commentators, and officials at regulatory agencies have raised concerns regarding the complexity of the Volcker Rule's restrictions, its associated compliance burdens, and its impact on liquidity. For example, the FRB's Vice Chairman for Supervision Randy Quarles recently described the Volcker Rule as "an example of a complex regulation that is not working well,"[3] and in testimony before Congress a SIFMA board member described the rule as "imposing an overly complex and intent-based compliance regime."[4] The new proposal seeks to simplify the regulations and streamline compliance, particularly for smaller banking organizations. The proposed revisions follow on the heels of other recent legislative efforts to reduce regulatory burdens in the banking sector, such as the enactment of the Economic Growth, Regulatory Relief, and Consumer Protection Act, which seeks to reduce burdens associated with enhanced prudential standards and other prudential requirements.[5]

Although the proposed revisions do not disturb the core principle that banks should not engage in speculative transactions for their own accounts, the proposal would make several key changes to the Volcker Rule, including:

- Limiting compliance obligations for banks without significant trading portfolios;
- Eliminating the rebuttable presumption that short-term trades are impermissible proprietary trading; and
- Establishing a presumption that underwriting and market-making activities within internal risk limits are permissible.

The proposal includes nearly 350 questions and requests for comment, suggesting that the Agencies view this proposal as a starting point and that they will be receptive to well-supported feedback from the industry and others. Banks should closely evaluate the proposal and consider whether additional revisions to the regulations would help reduce burdens or otherwise streamline compliance.

Overview of Key Changes to Volcker Rule

Tailoring regulations by size of trading assets and liabilities

The current regulations apply the same compliance requirements to all covered entities, resulting in disproportionate burdens on small and midsize banks. The proposal would divide banks into three categories: those with "significant trading assets and liabilities," meaning gross trading assets and liabilities of at least $10 billion; those with "moderate trading assets and liabilities," meaning gross trading assets and liabilities of $1 billion and less than $10 billion; and those with "limited trading assets and liabilities," meaning gross trading assets and liabilities of less than $1 billion.[6] Compliance burdens would scale with the size of the trading portfolio. Banks in the "limited trading assets and liabilities" category would be presumed to be in compliance with the Volcker Rule; banks in the "moderate trading assets and liabilities" category would have a limited set of compliance requirements, tailored to their size and complexity; and banks in the "significant trading assets and liabilities" category would be required to maintain a comprehensive compliance program.[7] The categories would not be absolute, and the Agencies would maintain the authority to move a bank up in category if warranted by the size or complexity of trading activities.[8]

Streamlining compliance with proprietary trading restrictions

The Volcker Rule's statutory prohibition defines "proprietary trading" as "engaging as a principal for the trading account of the banking entity."[9] The statute further defines "trading account" as "any account used for acquiring or taking positions . . . principally for the purpose of selling in the near term."[10] The existing regulations provide three "prongs" by which the Agencies determine whether an account is a trading account. The "short-term intent prong" includes any account used to purchase or sell financial instruments principally for short-term resale, benefiting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position.[11] Under this prong, any financial instrument held for less than 60 days (or for which the risk is transferred within 60 days) is presumed to have been purchased or sold for the trading account, with the burden of rebutting this presumption placed on the banking entity.[12] This presumption has created significant compliance burdens, particularly with respect to hedging activities, and can effectively penalize prudent risk-management practices. The "market risk capital prong" includes any account used to trade in instruments that are both market risk capital rule covered positions and trading positions (or hedges of such positions).[13] Finally, the "dealer prong" includes any account used by a banking entity that is licensed or registered (or required to be licensed or registered) as a dealer, swap dealer, or security-based swap dealer, to the extent the instrument is traded in connection with the activities requiring licensure or registration.[14]

The proposal generally would maintain the market risk capital and dealer prongs, with minor changes to the market risk capital prong intended to clarify application to foreign banking organizations.[15] The "short-term intent prong," however, would be removed and would be replaced by an "accounting prong" that would look to whether the account was used to trade in financial instruments recorded at fair value on a recurring basis under generally accepted accounting principles, which the Agencies state should cover derivatives, trading securities, and available-for-sale securities.[16] The proposal also would eliminate the rebuttable presumption of noncompliance for positions held for less than 60 days. Instead, banks not subject to the market capital risk or dealer prongs would be presumed to be in compliance with the Volcker Rule so long as each trading desk's cumulative net gain or loss over a 90-day period did not exceed $25 million.[17] The proposal has the potential to substantially reduce the compliance burdens associated with short-term trading activities and to allow a broader array of transactions.

In addition to revising the definition of "trading account," the proposal would expand or clarify several exclusions from the definition of "proprietary trading" and exemptions from the proprietary trading prohibition. The current exclusion for trades made in accordance with documented liquidity management plans would be expanded to include foreign exchange forwards, foreign exchange swaps, and physically settled cross-currency swaps.[18] Additionally, the market-making and underwriting exemptions would be clarified through the establishment of a presumption that trading within internal risk limits does not exceed the reasonably expected near-term demands of clients ("RENTD").[19] Finally, demonstrating permissible hedging would no longer require correlation analysis or showing that the hedge demonstrably reduces or significantly mitigates risk.[20] The proposed revision to the market-making and underwriting exemptions, in particular, has the potential to significantly simplify compliance and reduce associated expenses, as calculating the thresholds for these activities under the Volcker Rule as it currently exists has proven to be a difficult and costly exercise.

Limiting extraterritorial application

Congress exempted foreign banking entities from the scope of the Volcker Rule as to activities occurring outside the United States.[21] The current regulations apply this exemption to trades that satisfy several conditions: (i) the bank that engages as principal in the trade cannot be located in the United States, nor can "any personnel that arrange, negotiate, or execute" the trade; (ii) the bank that decides to engage in the trade cannot be located in the United States—the trade (including any hedges) cannot be accounted for as principal by any branch or affiliate located in the United States; (iii) no financing for the trade can be provided "directly or indirectly" by a branch or affiliate located in the United States; and (iv) the trade cannot be conducted with or through a US entity, with limited exceptions.[22] These conditions have in some instances created compliance burdens for foreign banks with a US presence without meaningfully reducing risks to the US financial system. For example, foreign banks with a US presence cannot use US-based personnel to negotiate foreign transactions, even where all risk is booked outside the United States. Foreign banking entities wishing to engage in such transactions with other foreign banking entities consequently must go through the burdensome process of confirming that their counterparties are not using US-based negotiators. Banks have been forced to respond by relocating key personnel outside of the United States, or even entirely avoiding trades with companies that have a US presence.

The proposal seeks to focus the exemption on the location of the booking risk, and would modify the requirement that no personnel who arrange, negotiate, or execute a trade may be located in the United States, instead requiring only that "relevant personnel" could not be so located.[23] The restriction on financing from US branches and affiliates would also be lifted, as would the prohibition on trades conducted with or through US entities.[24] Although these proposed changes should somewhat limit interference with foreign banking activities, there still remains the potential for significant extraterritorial application under the proposal.

Soliciting comments on covered funds

The proposed regulations would largely leave in place current restrictions on the ability of banks to own or invest in hedge funds and private equity funds. However, the proposal includes numerous requests for comment on potential changes to the definition of "covered fund" and the application of the restriction on ownership or interest in such funds. Requests cover topics including whether venture capital funds should be excluded,[25] whether definitions of "private equity" and "hedge fund" should be tied to existing SEC definitions,[26] whether the existing exclusion for foreign public funds is sufficiently expansive,[27] and whether the regulations should incorporate the exemptions in Section 23A of the Federal Reserve Act and Regulation W.[28] The proposal also asks for comment on the definition of the term "ownership interest" in the context of securitizations, and in particular, whether the Agencies should broaden the description of creditors' rights that would not constitute an ownership interest.[29]

These questions indicate that the Agencies may be open to changing key aspects of the regulations relating to covered funds. Banks should consider offering comments that include concrete and supportable proposals that are consistent with the statutory text.

Next Steps

Now that all relevant Agencies have approved release of the NPRM, it will be published in the Federal Register, and interested parties will have 60 days in which to submit comments. Given the high-profile nature of the rule and the large number of requests for comment included in the proposal, the rulemaking is likely to take a significant amount of time, and the comment period may be extended by the Agencies.

1. *Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, Notice of Proposed Rulemaking, Joint Banking Agencies (SEC, OCC, CFTC, FDIC, FRB) (June 5, 2018).

2. 12 C.F.R. § 248.2(c).

3. *The Federal Reserve's Regulatory Agenda for Foreign Banking Organizations: What Lies Ahead for Enhanced Prudential Standards and the Volcker Rule*, Vice Chairman for Supervision Randal K. Quarles (Mar. 5, 2018).

4. *Volcker Rule Testimony of SIFMA Witness Ron Kruszewski at HFSC Hearing* (Mar. 29, 2017).

5. P.L. 115-174.

6. NPRM at 55-56.

7. NPRM at 215.

8. *Id.*

9. 12 U.S.C. § 1851(h)(4).

10. 12 U.S.C. § 1851(h)(6).

11. *See, e.g.*, 12 CFR 248.3(b)(1); *see also* NPRM at 57.

12. *See* 12 CFR 248.3(b)(2); NPRM at 57.

13. *See* 12 CFR 248.3(b)(1)(ii); NPRM at 58.

14. *See* 12 CFR 248.3(b)(1)(iii); NPRM at 58.

15. NPRM at 60-61.

16. NPRM at 61-62.

17. NPRM at 69.

18. NPRM at 76.

19. NPRM at 90-93.

20. *See* 12 U.S.C. § 1851(d)(1)(H).

21. *See* 12 U.S.C. § 1851(d)(1)(H).

22. *See* 12 CFR 248.6(e)(3); NPRM at 138-139.

23. NPRM at 140.

24. NPRM at 141.

25. *See, e.g.*, Question 165, NPRM at 179.

26. *See, e.g.*, Question 160, NPRM at 176.

27. *See, e.g.*, Question 154, NPRM at 169-170.

28. *See, e.g.*, Question 158, NPRM at 175.

29. *See* Questions 176-180, NPRM at 186-189.

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