Memorandum

Federal Agencies Finalize Changes to Volcker Rule

August 21, 2019

Federal financial regulators responsible for implementing the Volcker Rule have issued a final rule to revise a number of provisions of the Volcker Rule's 2013 implementing regulations (the "2013 Rule"). The final rule, which is largely similar to the agencies' proposed rulemaking issued in June 2018, 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.

The final rule's changes relate primarily to the Volcker Rule's proprietary trading and compliance program requirements. While the agencies adopted certain limited changes to the Volcker Rule's covered fund-related provisions, the agencies noted that they continue to consider other aspects of the covered fund provisions on which they sought comment in the 2018 proposal, and intend to issue a separate proposed rulemaking that specifically addresses those areas.

The final rule will be effective on January 1, 2020. Banking entities will have a one-year grace period, until January 1, 2021, to fully comply with the final rule's amendments, but may also voluntarily comply, in whole or in part, with the amendments prior to such compliance date.

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

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 final rule revises 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 will be tailored as follows:

Consolidated Gross Trading Assets & Liabilities[1]	Compliance Program Requirements	CEO Attestation Requirement	Metrics Reporting Requirements	Additional Covered Fund Documentation
$20 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 $20 Billion (“Moderate”)	“Simplified” (Update existing policies and procedures)	No	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. Contrary to the proposal, the final rule eliminates the CEO attestation requirement for banking entities without significant trading assets and liabilities (unless otherwise required on a case-by-case basis).

Notably, the final rule entirely eliminates 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. In addition, the final rule amends 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.

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 final rule would amend both the “short-term intent prong” and the “market risk capital prong,” the “dealer prong” (covering the purchase or sale of

[1] The final rule calculates the trading assets and liabilities of FBOs by taking into account only the trading assets and liabilities of such banking entities’ combined U.S. operations.

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 substantively 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 would have replaced this "short-term intent prong" with a prong tied to the accounting treatment of a position (under which a "trading account" would have included 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), and would have presumed compliance for trading desks whose activities are not covered by the market risk capital prong or the dealer prong if the activities did not exceed a specified quantitative threshold. In response to strong industry opposition, however, the agencies dropped the proposed accounting prong from in the final rule and decided not to adopt the quantitative threshold-based presumption of compliance.

Instead, the final rule replaces 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) with a rebuttable presumption that financial instruments held for 60 days or more are *not* included in the banking entity's trading account under the short-term intent prong. In addition, banking entities that are subject to the market risk capital prong will not be subject to the short-term intent prong (although such banking entities may elect to apply the market risk capital rule prong as an alternative to the short-term intent prong under certain conditions).

2. Market Risk Capital Prong

The 2013 Rule's definition of "trading account" included any account used by a banking entity to purchase or sell financial instruments that are both covered positions and trading positions under the market risk capital rule (or hedges of other market risk capital rule covered positions), if the banking entity or any consolidated affiliate calculates risk-based capital ratios under the market risk capital rule.

The proposal would have would modified 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.

In the final rule, however, the agencies decided not to modify the market risk capital prong to incorporate foreign market risk capital frameworks, leaving the market risk capital prong substantially unchanged from the 2013 Rule. Instead, the agencies noted that FBOs that are not subject to the market risk capital rule may continue to use the short-term intent prong to define their trading accounts, or may elect to apply the market risk capital prong in determining the scope of its trading account (in which case it would not also be subject to the short-term intent prong).

The final rule does, however, add a one-year transition period for banking entities that later become subject to the market risk capital prong, and clarifies that whether a financial instrument is a "market risk capital rule covered position and trading position" for purposes of the market risk capital prong is determined without regard to whether the financial instrument is reported as a covered position or trading position on any applicable regulatory reporting forms.

3. Reservation of Authority

Under the proposal, the agencies would have reserved 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 (including by considering 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 final rule, however, does not include this proposed reservation of authority.

Exclusions and Exemptions From the Proprietary Trading Prohibition

The 2013 Rule contains various exclusions and exemptions from the scope of prohibited proprietary trading. The final rule would modify several of these exclusions and exemptions, as discussed below.

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 final rule amends this liquidity management exclusion substantially as proposed, permitting foreign exchange forwards, foreign exchange swaps and physically-settled cross-currency swaps, as well as non-deliverable cross-currency swaps, in each case 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 final rule adds 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 will 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. Contrary to the proposal, however, a banking entity would not be required under the final rule to transfer financial instruments purchased in error into a separately-managed trade error account for disposition.

3. Matched Derivative Transactions

The proposal requested comment on whether the agencies should exclude from the definition of proprietary trading loan-related swaps between a banking entity and customers that have received loans from the banking entity, which have presented a compliance challenge particularly for smaller non-dealer banking entities that enter into loan-related swaps infrequently.

In the final rule, the agencies have adopted an exclusion for a customer-driven swap or a customer-driven security-based swap and a matched swap or security-based swap if: (i) the transactions are entered into contemporaneously; (ii) the banking entity retains no more than minimal price risk; and (iii) the banking entity is not a registered dealer, swap dealer, or security-based swap dealer. This exclusion in the final rule is not limited to loan-related swaps, and thus could apply to a swap with a customer in connection with the customer's end-user activity.

4. 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 final rule establishes 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 final rule. The final rule also amends 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.

The limits used to satisfy the presumption of compliance under the final rule will be subject to supervisory review and oversight by the applicable agency on an ongoing basis. Moreover, the final rule provides that the

presumption of compliance may be rebutted by the applicable agency if such agency determines, taking into account the liquidity, maturity, and depth of the market for the relevant types of financial instruments and based on all relevant facts and circumstances, that a trading desk is engaging in activity that is not designed not to exceed RENTD. The final rule modifies the proposal to specify that the agencies will take into account the liquidity, maturity, and depth of the market for the relevant types of financial instruments when determining whether to rebut the presumption of compliance.

Contrary to the proposal, the final rule does not require that a banking entity promptly report to the appropriate agency when a trading desk exceeds or increases its internal limits to avail itself of the RENTD presumption for the underwriting and market-making exemptions. Instead, the final rule requires banking entities to maintain and make available to the applicable agency, upon request, records regarding (1) any limit that is exceeded and (2) any temporary or permanent increase to any limit, in each case in the form and manner as directed by the agency.

5. 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 final rule removes 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 final rule also eliminates 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. In addition, the final rule reduces the documentation requirements associated with certain risk-mitigating hedging transactions.

6. 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 final rule removes 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 final rule also eliminates 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.

7. Other Added Exclusions

The final rule excludes from the trading account any purchase or sale of a financial instrument that does not meet the definition of "trading asset" or "trading liability" under the banking entity's applicable reporting form. The final rule also excludes from the definition of proprietary trading any purchase or sale of financial instruments that the banking entity uses to hedge mortgage servicing rights or mortgage servicing assets in accordance with a documented hedging strategy.

Covered Fund Activities and Investments

While the proposal included certain limited proposed revisions to the Volcker Rule's covered fund provisions, it also sought comments on other aspects of the covered fund provisions beyond those changes for which specific rule text was proposed. In the final rule, however, the agencies determined to adopt only those covered fund-related provisions for which specific rule text was proposed (and, in each case, substantially as proposed). The agencies noted that they continue to consider other aspects of the covered fund provisions and intend to issue a separate proposed rulemaking that specifically addresses those areas.

1. 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 and its Tier 1 capital deduction (as well as its per-fund limit if the banking entity acts as sponsor or acquires an interest in the fund pursuant to the asset management or asset-backed security issuer exemptions).

The final rule eliminates 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 organize or offer that covered fund. The agencies continue to consider whether the approach being adopted in the final rule may be extended to other issuers, such as funds advised by the banking entity, and intend to address and request additional comment on this issue in the future proposed rulemaking.

2. Risk-Mitigating Hedging Activities

The final rule expands 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 final rule allows 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.

3. 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 final rule effectively codifies 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 final rule also clarifies that if the banking entity or an affiliate sponsors or serves as the investment manager or adviser to a covered fund, then the banking entity or affiliate will be deemed for purposes of the marketing restriction to participate in any offer or sale of ownership interests in the covered fund.

The final rule also eliminates 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.

4. Covered Fund Provisions Possibly Subject to Future Proposals

As noted above, the agencies noted that they continue to consider covered fund-related provisions other than those for which specific rule text was proposed, which they intend to address in a separately issued future proposal. Possible provisions that could be addressed in such a future rulemaking include the following:

- *Definition of "Covered Fund"*: The agencies previously sought 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 which would exclude from the definition of "covered fund" entities that lack certain characteristics commonly associated with hedge funds or private equity funds.

- *<u>"Super 23A" Limitations on Relationships With a Covered Fund</u>*: 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, but does not incorporate or reference the exemptions from such affiliate transaction restrictions contained in Section 23A or the Federal Reserve's Regulation W. The agencies have previously sought 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.
- *<u>Treatment of Regulated Investment Companies and Certain Foreign Funds</u>*: 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 previously sought comment regarding the issues raised by the interaction between the 2013 Rule's definitions of "banking entity" and "covered fund."

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