



## Volcker Rule 2.0: A Significant but Unfinished Proposal

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The federal agencies responsible for implementing the Volcker Rule—the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC)—recently proposed significant changes to the final rule that they adopted in 2013. At that time, the agencies were charged with a difficult task: implementing a provision of the Dodd-Frank Act that was hastily and broadly drafted, despite its changing fundamentally the way that large banking organizations operate by preventing them from engaging in proprietary trading or investing in hedge funds and private equity funds (called “covered funds” in the final rule). In those circumstances, the agencies produced, perhaps inevitably, a final rule that was highly complex and burdensome, and that may well have resulted in unintended consequences.

It comes as no surprise that in the years since the final rule was adopted, there is widespread recognition that those consequences were exactly the result of the Volcker Rule. This recognition comes not only from the banking and financial services industry, but also from legislators and even from the federal agencies themselves. The agencies now have several years of experience and data based on the current final rule. Although calls for a wholesale repeal of the Volcker Rule are now few and far between, there has developed a growing and meaningful consensus that the final rule adopted by the agencies in 2013 can be simplified and its compliance burdens reduced without abandoning the Volcker Rule’s core requirements.

For example, the U.S. Treasury Department issued a report in 2017 that recommended modifications to the Volcker Rule that would reduce compliance burdens and simplify some of the more complex requirements. Following that report, the OCC formally sought public input on potential changes to the Volcker Rule. Although the OCC did not propose specific rule changes, the notice appeared to favor changes that would relieve some of the burdens of compliance. In May, 2018, Congress passed the Economic Growth, Regulatory Relief, and Consumer Protection Act, which amended the Volcker Rule’s statutory provisions to exempt small institutions with limited trading operations and to further limit the name-sharing restrictions of the rule.

The agencies have proposed their rule changes in the context of those developments, following the appointment by the current administration of many of the top officials at those agencies. The core requirements of the rule—prohibiting proprietary trading and limiting the ability of banks to own or sponsor covered funds—would remain intact. In addition, a few of the proposed

changes—such as the new “accounting prong” of the proprietary trading definition (discussed below)—would actually broaden the final rule’s restrictions. Overall, however, the proposed changes would be a shift from an overly prescriptive, highly complex approach to rule making to one that is somewhat more principles-based and results in less burden from a day-to-day compliance perspective. The proposed changes would also reduce the extraterritorial effect of the final rule to some extent.

Despite suggesting many changes, the agencies have left open many of the issues and interpretive questions that resulted from the final rule, especially those related to covered fund restrictions.

In the balance of this post, we will evaluate how some of the specific proposed changes and requests for comment could affect banks and their affiliates.

## Bank Size and Compliance Program Requirements

The existing regulations recognize that one size does not fit all with respect to compliance programs. The proposed changes reinforce that point and simplify the approach to compliance programs even further.

### **Categorizing Banks Solely by Trading Assets and Liabilities**

Under the existing regulations, banks are categorized by two measures: levels of trading assets and liabilities; and levels of total consolidated assets. The agencies now propose to remove the second measurement—asset size alone—from their regulations. The obligations of banks under the proposed rule would be primarily determined by levels of trading assets and liabilities.

The proposed changes would assign each banking organization to one of three categories based on its trading assets and liabilities: (i) \$10 billion or more (called “significant”); (ii) \$1 billion or more (called “moderate”); and (iii) less than \$1 billion (called “limited”). Accordingly, an organization’s total consolidated asset size would no longer matter.

### **Scaling Back Compliance Program Requirements**

The agencies propose to reduce compliance program requirements for many banking entities, including the very largest. Significantly, the proposal would eliminate, for the largest banking entities (i.e., those with “significant” trading assets and liabilities), the detailed enhanced compliance program requirements set forth in Appendix B of the existing rule, with one exception (the CEO attestation requirement). The enhanced minimum standards are a detailed and prescriptive elaboration of the basic compliance program requirements set forth in the final rule for all banking entities. Although Appendix B would be eliminated, banking entities with significant trading assets and liabilities would remain subject to the standard six-pillar compliance program requirement articulated in the existing rule.

The next category of banking entities—those with “moderate” trading assets and liabilities—would be subject to the requirements for “simplified compliance programs” that currently apply to banking entities with total consolidated assets of \$10 billion or less. Thus, a banking entity that had less than \$10 billion of trading assets and liabilities would, no matter how large its balance

sheet, satisfy the proposed rule's compliance program requirement "by including in its existing compliance policies and procedures appropriate references to the requirements of [the Volcker Rule and implementing regulations] and adjustments as appropriate given the activities, size, scope, and complexity of the banking entity."

The final category of banking entities—those with "limited" trading assets and liabilities of less than \$1 billion—would be presumed to be in compliance and would have no obligation to affirmatively demonstrate compliance to their regulators on an ongoing basis. Those banking entities would remain subject to the requirements of the Volcker Rule, but not to the separate obligations to demonstrate and monitor compliance on an ongoing basis.

As a practical matter, however, all banking entities (other than those community banks and small institutions exempted by the amended statute) would still need to ensure compliance with the rule in a manner appropriate for their businesses. Failures to comply with the proprietary trading or covered fund restrictions of the rule could still result in penalties, and regulators would have the authority to impose heightened compliance program requirements in those circumstances.

## Proprietary Trading

### Identifying Proprietary Trading

Under the existing rule, whether a given purchase or sale of a financial instrument by a bank is subject to restrictions on proprietary trading turns, in the first instance, on whether the bank engages in the transaction for the bank's "trading account" as defined under the regulations. That definition has three prongs. The agencies propose to eliminate one of the prongs—the "short-term intent" prong—and they propose to add a new prong in its place—the "accounting" prong.

*Short-Term Intent Prong.* The short-term intent prong, which the agencies propose to remove, ties to a bank's subjective intent when it engages in trading activities. That prong is triggered when purchases or sales of financial instruments are principally for the purpose of short-term resale or other short-term purposes. The agencies explained their proposal to remove the prong by noting that, in their experience, "determining whether or not positions fall into the short-term intent prong of the trading account definition has often proved unclear and subjective, and, consequently, may result in ambiguity or added costs and delays." Along with the short-term intent prong, the agencies propose to eliminate the rebuttable presumption that trades within 60 days or fewer are for the trading account of the banking entity. (There was no reverse presumption for trades longer than 60 days.)

Given the inherent uncertainties related to any inquiry into subjective intent—and particularly the subjective intent of a banking organization—eliminating this element of the definition would make application of the rule more objective and less complex. However, to effect the proposed change, the agencies must overcome a statutory hurdle: the short-term intent prong of their regulatory definition echoes the Volcker Rule's own statutory definition of "trading account," which includes the phrase "principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)." The agencies appear to address this concern by replacing the short-term intent prong with the new accounting prong.

*Accounting Prong.* The new accounting prong is tied to the accounting treatment of financial instruments. If a financial instrument is “recorded at fair value on a recurring basis” under generally accepted accounting principles (GAAP), then any purchase or sale of the financial instrument would amount to proprietary trading.

This change to the definition would expand the Volcker Rule’s prohibition on proprietary trading significantly. For example, we understand that many financial instruments that are categorized by banks under GAAP as “available for sale”—and thus would be recorded at fair value on a recurring basis—are held for various purposes that may have little to do with what is commonly understood to be proprietary trading. Derivative instruments are also typically recorded at fair value.

The agencies offer some relief from the proposed accounting prong’s breadth by creating a rebuttable presumption of compliance if certain conditions are met. The presumption would cover, for example, transactions undertaken by a “trading desk” (as defined in the rule) if the trading desk’s trading activities remained below a quantitative limit (generally speaking, no more than \$25 million of gross trading losses and gains during any 90-day period). The practical impact of this rebuttable presumption remains to be seen; however, in its current form, it is unlikely that it would adequately offset the expansion of the rule that would result from the addition of the accounting prong.

### **Underwriting, Market-Making and Hedging**

The existing regulations permit banks to engage in underwriting, market-making and hedging transactions if, in each case, detailed conditions are satisfied. The agencies propose to pare back some of the prescriptive nature of those conditions, while leaving the basic requirements in place.

*Separate Compliance Program Requirements.* One set of changes addresses the compliance program requirements that the existing regulations impose on banks seeking to qualify particular trading activities as permissible underwriting, market-making or hedging, which are separate from the existing regulations’ more general compliance program requirements (discussed above). The proposed rule would lift the separate compliance requirements for banks whose trading assets and liabilities qualify as moderate (less than \$10 billion) or limited (less than \$1 billion). Such banks would generally remain subject to the other requirements associated with the underwriting, market-making or hedging exemptions, but they would be able to implement related compliance programs of their own design, thus lessening their overall compliance burdens.

*Underwriting and Market-Making: RENTD.* The exemptions for underwriting and market-making are each conditioned on related trading positions not exceeding “reasonably expected near term demand of clients, customers and counterparties”—or “RENTD.” Banks seeking to qualify trading as permissible underwriting or market-making must, as required by the statute, monitor RENTD. The statute did not provide any guidance regarding RENTD, and the existing rule contains RENTD requirements that are detailed and prescriptive. Those requirements embody a one-size-fits-all approach, despite the facts that (i) the statute did not require such an approach, and (ii) there are a variety of reasonable ways that banks can monitor and report their underwriting and market-making activities for other compliance and risk management purposes.

The proposed rule would permit a banking entity to create its own internal risk limits related to underwriting and market-making, and the bank would be presumed to be in compliance with the regulations' RENTD requirements as long as those limits were respected. Importantly, and perhaps obviously, the risk limits would themselves be subject to agency review and, in effect, approval. Thus, the regulations would adopt a more principles-based, and less rules-based, approach to the complex question of distinguishing proprietary trading from underwriting and market-making. We believe that the agencies and banks alike would benefit from such an approach.

*Hedging: Correlation Analysis.* The current regulations require that banks undertake correlation analyses with respect to any trading that qualifies as permissible hedging. Thus, banks are currently required to “demonstrate that the hedging activity demonstrably reduces or otherwise significantly mitigates the specific, identifiable risk(s) being hedged.” The agencies propose to eliminate this after-the-fact correlation analysis requirement. The agencies would nonetheless retain the requirement that the banks' compliance programs be designed up front to reduce “one or more specific, identifiable risks.”

### **Trading Outside the United States (TOTUS)**

The existing regulations apply to foreign banking organizations (FBOs) having a branch or agency in the United States. However, the regulations exempt an FBO's trading outside the United States if the activities meet certain conditions—the so-called “TOTUS” exemption. The agencies now propose to liberalize three of the TOTUS conditions.

Under the existing rule, TOTUS is available only if none of the FBO's personnel who “arrange, negotiate or execute” the purchases or sales in question is located in the United States. Thus, FBOs must monitor a broad range of activities of their personnel to take advantage of TOTUS. The agencies propose to eliminate that condition. There would remain the existing condition that personnel who “make the decision” to purchase or sell must not be located in the United States.

The second condition that would be changed prevents an FBO from taking advantage of the TOTUS exemption to the extent it trades with or through U.S. entities, except in certain circumstances. Either the U.S. entity must trade from outside the United States—using the same standard regarding personnel being “involved in the arrangement, negotiation, or execution” of transactions—or the trading must take place in a centrally cleared market. The proposed rule would entirely eliminate the restriction on trading with or through a U.S. entity if the other conditions of TOTUS are satisfied. (The U.S. entity, however, if it were subject to the Volcker Rule, would not be able to rely on this exemption.)

The third proposed change removes a condition related to the location from which an FBO finances its trading. Collectively, these proposed changes would permit a broader range of FBO activity consistent with TOTUS, without diluting the primary related policy goal: that any resulting trading risk be borne financially by the FBO outside the United States.

### **Covered Fund Activities**

The existing rule limits the ability of banks to own or sponsor “covered funds” or to engage in certain kinds of transactions with such funds. A threshold observation is in order regarding how

the agencies address covered fund activities in their proposal: they propose very few changes to the existing regulations, but they ask quite a few leading questions. That approach, as contrasted with their approach to proprietary trading, suggests that the agencies have given ample thought to revising the covered fund elements of their existing regulations, but are perhaps less sure collectively how best to proceed. We will touch on a few of their questions here.

*Definition of Covered Fund.* The regulatory definition of covered fund takes its cue from the statutory definition of hedge fund and private equity fund. Both cover entities that would be investment companies under the Investment Company Act of 1940 but for either Section 3(c)(1) or 3(c)(7) of the Act (the private fund exemptions). As the agencies acknowledged when they adopted the final rule, the definitions cover many entities that, in common parlance, are not hedge funds or private equity funds. In their proposal, the agencies ask several questions suggesting that they may consider amendments that would focus Volcker Rule obligations more narrowly on entities that have trading or investing activities typical of hedge funds and private equity funds.

*Securitizations.* Many securitization issuers do not engage in trading or investing activities that are typical of hedge funds and private equity funds, but they are nonetheless often covered funds under the existing regulations. The regulations exclude “loan securitization” issuers from the definition of covered fund, but the conditions of that exclusion are inconsistent with pre-financial crisis practices in the loan securitization market. The agencies request comment regarding whether the loan securitization exclusion should be amended to permit the pre-crisis practice of a loan securitization issuer holding a limited number of debt securities in addition to its portfolio of loans.

The agencies also seek comment regarding a second aspect of the existing regulations that has proven troublesome for the securitization markets: whether the definition of “ownership interest”—the final rule prohibits a banking entity from acquiring or retaining an “ownership interest” in a covered fund—is overly broad because it includes certain rights associated with creditors, rather than owners, of securitization issuers. That definition seems to have been crafted with a view toward anticipating and eliminating every possible means by which banks might take advantage of less prescriptive rules, rather than with a view toward establishing more general standards and supervising the banks as the standards are applied.

*Hedging.* When the current regulations were finalized, the agencies did not include provisions from their original proposal that would permit banks to hold covered fund ownership interests as hedges for customer transactions. The agencies are now revisiting their decision not to include the provisions in the final regulations, as they seek comment regarding whether to add them now. If added, the provisions would permit banks to reengage in a form of customer business that was common before the Volcker Rule. For example, banks would once again be able to hedge, and thus to enter into, customer swaps and other derivatives that are tied to the performance of hedge funds. They would thus be able once again to provide customers synthetic exposure to hedge funds.

## Super 23A Restrictions

The Volcker Rule restricts the ability of a banking entity that sponsors or advises a covered fund from entering into transactions that would result in the banking entity having credit exposure to the covered fund, such as a loan to a covered fund. Those restrictions were modeled on the

restrictions in Section 23A of the Federal Reserve Act, which limit the transactions that an insured depository institution may enter into with its affiliates (e.g., its bank holding company parent). However, the covered fund restrictions in the Volcker Rule do not include certain exceptions that are included in the general Section 23A restrictions (such as exempting transactions fully secured by U.S. Treasury securities). Thus, the provisions have been referred to as “Super 23A” restrictions.

The agencies are now seeking comment that suggests that they are revisiting whether the Super 23A restrictions should be subject to Section 23A-like exceptions (thus making Super 23A a little less “super”). However, in order to amend the regulations accordingly, the agencies would need to change the statutory interpretation that they adopted when the regulations were finalized. In the earlier context, the agencies determined that the Volcker Rule statutory provisions did not permit the exceptions that they are now considering. Now the agencies seek comment regarding their previous statutory interpretation.

## Conclusion

As the agencies consider whether and how to adopt the proposed rule, comments submitted in response to the notice of proposed rulemaking will be important. Those comments will influence, among other things, whether the agencies propose additional changes or take other action (such as adopting an interim final rule) with respect to the range of subjects—particularly in the covered fund area—about which they asked questions but proposed few changes to the rule text. Comments are due September 17, 2018, and generally will be accepted from the industry, the public and other interested parties.

The proposed rule would represent a welcome shift from the prescriptive rules-based approach of the existing rule to a more principles-based approach. The agencies can implement the core restrictions of the Volcker Rule—prohibiting proprietary trading and investments in hedge funds and private equity funds—without a rule that is as detailed and as prescriptive as the current rule. Reducing compliance burdens, while maintaining the core requirements of the regulations is sensible. The agencies’ proposal is a useful step in the direction of a more balanced regulatory approach.