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SIDLEY UPDATE

Federal Agencies Amend the Volcker Rule's Covered Fund Restrictions, Completing Series of Related Rulemakings

July 20, 2020

In July 2018, the U.S. federal agencies that administer the Volcker Rule (collectively, the Agencies)[1] initiated a series of proposed rulemakings[2] to amend the original regulations implementing the Volcker Rule.[3] The Agencies amended the Volcker Rule's proprietary trading restrictions and compliance requirements in November 2019 (the 2019 Revisions).[4] The Agencies amended the Volcker Rule's covered fund restrictions on June 25, 2020 (the 2020 Revisions).[5] The amendments generally leave intact the original regulation's core restrictions on covered fund activities and proprietary trading while providing relief from many of the Volcker Rule's restrictions and simplifying how banking entities may comply with the restrictions as they remain.

This Sidley Update focuses on the 2020 Revisions; it also includes, in Annex A, a recap of the 2019 Revisions.[6] We use the term Original Rule to refer to the original regulations implementing the Volcker Rule and the term Revised Rule to refer to the Volcker Rule as amended.

The 2020 Revisions will take effect October 1, 2020. The 2019 Revisions are effective, but compliance is not required until January 1, 2021; however, banking entities may elect to comply with the Original Rule as modified by the 2019 Revisions at any time prior to January 1, 2021.

Key Changes Made by the 2020 Revisions

The key changes made by the 2020 Revisions are:

- narrow the existing definition of "ownership interest"
- add further exclusions from the definition of "covered fund" for certain qualifying credit funds, venture capital funds, family wealth management vehicles, and customer facilitation vehicles
- broaden certain existing exclusions from the definition of "covered fund"
- codify the Agencies' prior no-action position with respect to certain "foreign excluded funds"
- provide a range of exemptions from the Original Rule's so-called "Super 23A" restrictions, which otherwise prohibit certain transactions between banking entities and covered funds that they sponsor or advise
- add a rule of construction to clarify that if a banking entity makes direct investments in parallel with investments made by a covered fund that the banking entity organizes and offers (as elsewhere permitted by the Original Rules), those direct investments will not be counted against limitations

imposed on the banking entity's ability to acquire and retain ownership interests in such covered fund if certain conditions are satisfied

The 2020 Revisions are in addition to the small number of changes that the 2019 Revisions made to the Volcker Rule's covered fund restrictions (along with the 2019 Revisions' more extensive changes to the proprietary trading restrictions and compliance requirements). For completeness, we discuss the earlier covered fund changes after discussing the 2020 Revisions.

Narrowing the Existing Definition of "Ownership Interest"

The Original Rule's definition of "ownership interest" included debt obligations of covered funds if related creditors had

> the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event).[7]

This clause covered certain debt securities issued in securitizations (e.g., debt securities of collateralized loan obligations or CLOs) that give holders rights related to the replacement of investment managers (such as CLO collateral managers). Market participants historically considered such rights to be the rights of creditors (rather than the rights of owners). Thus, the Original Rule resulted in changes in market practice because ownership of these debt securities was considered an ownership interest in the issuer for purposes of the Volcker Rule.

The 2020 Revisions make two changes to the definition of "ownership interest." First, the 2020 Revisions amend the definition of "ownership interest" so that providing the holder "the right to participate in the removal of an investment manager for 'cause' or participate in the selection of a replacement manager upon an investment manager's resignation or removal" does not result in an interest being an ownership interest.

The 2020 Rule Proposal included a narrower exclusion, which was available only in the case of "an event of default or an acceleration event." The Agencies asked in the 2020 Rule Proposal whether the exclusion should be "expanded to include the right to participate in any removal of an investment manager for cause, or to nominate or vote on a nominated replacement manager upon an investment manager's resignation or removal, whether or not an event of default or an acceleration event has occurred?"[8] The 2020 Revisions broadened the exclusion accordingly.

Second, the 2020 Revisions add a safe harbor for senior loans or senior debt interests having certain economic characteristics (regardless of the presence of any consent or other noneconomic creditor protection rights). To qualify for the safe harbor, the senior loan or senior debt interest must have the following characteristics:

- Under the terms of the loan or interest, holders do not have the right to receive a share of the income, gains, or profits of the covered fund but are entitled to receive only
    - interest at a stated interest rate as well as commitment fees or other fees, which are not determined by reference to the performance of the underlying assets of the covered fund and
    - repayment of a fixed principal amount on or before a maturity date in a contractually determined manner (which may include prepayment premiums intended solely to reflect, and compensate holders of the interest for, forgone income resulting from an early prepayment)
- The entitlement to payments under the terms of the interest are absolute and cannot be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses,

write-downs, or charge-offs of the outstanding principal balance or reductions in the amount of interest due and payable on the interest.

- The holders of the interest are not entitled to receive the underlying assets of the covered fund after all other interests have been redeemed or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event).

Commenters had requested that the Agencies provide guidance regarding the meaning of “senior” in the phrase “senior loan or senior debt interest.” In particular, commenters requested that the Agencies make it clear that investment-grade debt would be considered “senior” for such purposes. However, the Agencies declined to provide any guidance. Moreover, the Agencies noted, with respect to the requested “investment grade” provision, that “such a provision would not ensure that debt interests that have equity-like characteristics are treated as ownership interests.”[9]

New Exclusions From the Definition of “Covered Fund”

The Original Rule set forth 14 exclusions from the definition of “covered fund.” The 2020 Revisions will add four new exclusions:

- credit funds
- venture capital funds
- family wealth management vehicles
- customer facilitation vehicles

Credit Funds

The 2020 Revisions add an exclusion for issuers that are qualifying credit funds, which will complement the existing exclusion for issuers that are qualifying loan securitization entities (LSEs). Both kinds of issuers hold fixed income assets. Both kinds of issuers might rely on the investment company exemption set forth in Section 3(c)(1) or 3(c)(7) of the Investment Company Act and thus are “covered funds” (before the application of any exclusion).

The key differences between the two kinds of issuers are:

- Credit funds may not be issuers of asset-backed securities (unlike LSEs, which must be issuers of asset-backed securities); and

- Credit funds are permitted to hold many kinds of fixed income obligations, including bonds, other debt securities and certain equity securities received in connection with fixed income activities (unlike LSEs, which may hold loans and generally may not hold debt or other securities — though, as described below, the 2020 Revisions now will permit LSEs to hold a small amount of debt securities).[10]

To be eligible for the exclusion, a credit fund’s assets must be limited to loans, debt instruments, certain rights, and other assets related or incidental to acquiring, holding, servicing, or selling such loans or debt instruments (e.g.,, securities received in lieu of debt previously contracted, or equity “kickers” or warrants received on customary terms), and certain interest rate or foreign exchange derivatives that reduce interest rate or foreign exchange risk of other permissible assets of the credit fund.

In addition, the credit fund will also be subject to limitations on its activities, including not issuing asset-backed securities (as noted above) and not engaging in proprietary trading (as defined in the Volcker Rule's short-term intent prong). Moreover, a banking entity may not rely on the exclusion with respect to a given credit fund if (i) the banking entity guarantees or insures the obligations of the issuer or (ii) the credit fund holds assets that would be impermissible for the banking entity to acquire and hold directly under applicable federal banking laws and regulations. A banking entity's investment in and relationships with the excluded credit fund must satisfy the prudential backstop restrictions of the Volcker Rule (e.g., the provisions that address material conflicts of interest generally) and otherwise be in compliance with applicable safety and soundness standards. If the banking entity acts as the issuer's sponsor, investment adviser, or commodity trading adviser, the banking entity will be required (i) to make certain related disclosures to investors, similar to those required under the asset management exemption, (ii) to ensure that the activities of the issuer are consistent with safety and soundness standards substantially similar to those that would apply if the banking entity directly engaged in the activities, and (iii) to comply with the Volcker Rule's Super 23A restrictions as if the issuer were a covered fund, except that the banking entity may acquire and retain ownership interests in the credit fund.

Venture Capital Funds

Venture capital funds generally rely on the investment company exemption set forth in Section 3(c)(1) or 3(c)(7) of the Investment Company Act and thus are "covered funds" (before the application of any exclusion). The exclusion for venture capital funds in the Revised Rule is based on the premise that venture capital funds can be distinguished from the kind of private equity funds the Volcker Rule is intended to cover.

A venture capital fund is eligible for the exclusion if it does not engage in proprietary trading (as defined in the Volcker Rule's short-term intent prong) and satisfies the SEC's existing definition of "venture capital fund." That definition will require that any qualifying venture capital fund

- represent to investors and potential investors that it pursues a venture capital strategy
- hold, immediately after the acquisition of any asset (with limited exceptions), no more than 20 percent of the amount of the fund's aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) other than equity securities of companies typically held by venture capital funds
- not borrow, issue debt obligations, provide guarantees, or otherwise incur leverage in excess of 15 percent of the private fund's aggregate capital contributions and uncalled committed capital or that has a term longer than 120 days
- only issue securities the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem, or require the repurchase of such securities and
- not register as an investment company, and not be treated as a business development company, under the Investment Company Act[11]

Like the exclusion for credit funds, the exclusion for venture capital funds is conditioned on the relying banking entity's not insuring or guaranteeing the obligations of the excluded venture capital fund. In addition, the banking entity's investment in and relationships with the excluded venture capital fund must comply with the prudential backstop restrictions of the Revised Rule (e.g., the provisions that address material conflicts of interest generally) and otherwise be in compliance with applicable safety and soundness standards.

In addition, any banking entity that acts as the excluded venture capital fund's sponsor, investment adviser, or commodity trading adviser will be required (i) to make related disclosures to investors similar to those required under the Volcker Rule's asset management exemption, (ii) to ensure that the activities of the excluded venture capital fund are consistent with safety and soundness standards, and (iii) to comply with Super 23A restrictions as if the excluded venture capital fund were a covered fund.

Family Wealth Management Vehicles

The exclusion for family wealth management vehicles will be available to entities that, broadly speaking, are entirely owned by members of the same family and, at most, five others who are closely related persons of the family members (limited third-party ownership is also permitted for establishing corporate separateness or bankruptcy remoteness).

To rely on the exclusion for family wealth management vehicles, banking entities must satisfy several additional criteria, including these:

- The banking entity must provide bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to the excluded family wealth management vehicle.
- The banking entity may not insure or guarantee the obligations of the excluded family wealth management vehicle.
- The banking entity must make certain disclosures to investors, similar to those required under the Volcker Rule's asset management exemption.
- The banking entity generally cannot have an ownership interest in the excluded family wealth management vehicle.
- The banking entity must comply with the prudential backstop restrictions of the Revised Rule (e.g., the provisions that address material conflicts of interest generally).
- The banking entity must comply with the restrictions of "Super 23B" with respect to the excluded family wealth management vehicle.
- The banking entity must comply with the prohibition in the Federal Reserve Board's regulations implementing Section 23A of the Federal Reserve Act on the purchase of low-quality assets from the excluded family wealth management vehicle (other than for certain riskless principal transactions).

Customer Facilitation Vehicles

The exclusion for customer facilitation vehicles will be available for certain entities that are created to facilitate a banking entity customer's exposures to a transaction, investment strategy, or other service offered by the banking entity.

The principal conditions of the exclusion are:

- The customer facilitation vehicle is formed by or at the request of the banking entity's customer for the purpose of the banking entity's providing such customer (including one or more of its affiliates) with exposure to a transaction, investment strategy, or other service provided by the banking entity (and the banking entity retains documentation demonstrating how this will occur).
- All of the ownership interests of the customer facilitation vehicle are owned by the customer and its affiliates (other than up to 0.5 percent, which may be owned by the banking entity or one or more third parties in order to achieve corporate separateness or bankruptcy remoteness).

- The banking entity makes certain disclosures to the customer, similar to those required under the Volcker Rule's asset management exemption.

- The banking entity generally cannot hold an ownership interest in the customer facilitation vehicle.

- The banking entity must comply with the prudential backstop restrictions of the Revised Rule (e.g., the provisions that address material conflicts of interest generally).

- The banking entity must comply with the restrictions of "Super 23B" with respect to the customer facilitation vehicle; and

- The banking entity must comply with the prohibition, found in the Federal Reserve Board's regulations implementing Section 23A of the Federal Reserve Act, on the purchase of low-quality assets from the customer facilitation vehicle (other than for certain riskless principal transactions).

Although one commenter requested that the exclusion not be conditioned on a requirement that each qualifying customer facilitation vehicle be formed "by or at the request of a customer," the 2020 Revisions retained the requirement. However, the Agencies clarified that

> the requirement will not preclude a banking entity from marketing its customer facilitation vehicle services or discussing with its customers prior to the formation of such vehicles the potential benefits of structuring such services through a vehicle.[12]

Existing Exclusions From the Definition of "Covered Fund"

Foreign Public Funds

The 2020 Revisions adjusted the exclusion for foreign public funds. The Agencies noted that the existing exclusion is intended to ensure that non-U.S. public funds that are similar to investment companies registered under the Investment Company Act are not treated as covered funds.

The adjustments will remove the condition that the foreign public fund "[s]ells ownership interests *predominantly* through one or more public offerings outside the United States" (emphasis added). In the 2020 Adopting Release, the Agencies observe that they had "stated in the preamble to the [Original Rule] that they generally expect that an offering is made predominantly outside of the United States if 85 percent or more of the fund's interests are sold to investors that are not residents of the United States."[13] In the 2020 Rule Proposal, the Agencies acknowledged that "the requirement that a fund be sold 'predominantly' through one or more public offerings may cause certain compliance and monitoring difficulties."[14]

Thus, the Revised Rule will eliminate the Original Rule's "predominately" condition. The Revised Rule includes a simpler condition requiring that an excluded foreign public fund's "[ownership] interests are offered and sold, through one or more public offerings." The definition of "public offering" is limited to a "distribution" of securities in one or more non-U.S. jurisdictions to investors, including retail investors, that

- is subject to substantive disclosure and retail investor protection laws or regulations (not necessarily required to be in the "home jurisdiction")

- does not restrict availability to investors with minimum net worth or net investment assets

- if the banking entity is the investment manager, investment adviser, commodity trading adviser, commodity pool operator, or sponsor, complies with all applicable requirements in the jurisdiction in which it is made and

- includes publicly available offering disclosure documents submitted or filed with the appropriate regulatory authority

Where a U.S. banking entity sponsors the foreign public fund, the agencies reduced (from 85 percent to 75 percent) the minimum amount of ownership interests that must be sold to persons other than the U.S. banking entity, the issuer, their respective affiliates, and the directors and senior executive officers (a change from "all employees") of the foregoing entities.

Loan Securitizations

The Volcker Rule's statutory authority states that it should not be "construed to limit or restrict the ability of a banking entity ... to sell or securitize loans in a manner otherwise permitted by law."[15] Accordingly, as noted, the Original Rule included a covered fund exclusion for LSEs. One of the conditions for that exclusion is that a qualifying issuer may not (with few narrow exceptions) hold bonds or other debt securities. That restriction was inconsistent with pre-Volcker Rule market practices for CLOs, which often held a small portion of their assets in the form of bonds or other debt securities (so-called "bond buckets").

The 2020 Revisions will permit LSEs to hold debt securities, subject to a cap. The amended exclusion will permit a qualifying issuer to invest a small portion of its assets — 5 percent — in debt securities (other than asset-backed securities and convertible securities). The additional flexibility will allow CLOs to have bond buckets as they often did before the Volcker Rule was adopted. The Revised Rule prescribes a methodology for calculating the 5 percent threshold.

Foreign Excluded Funds

Since the Original Rule was adopted, foreign banking organizations (FBOs) have expressed concern about the interplay of different provisions of the Volcker Rule as they apply to certain non-U.S. fund entities that are offered and sold entirely outside the United States. Such funds are beyond the Investment Company Act's jurisdictional reach and thus do not rely on its Section 3(c)(1) or 3(c)(7) to avoid registration as investment companies. Thus, such funds are typically not covered funds, and FBOs may sponsor and invest in such funds — which are referred to as "foreign excluded funds" — without restriction.

However, if an FBO owns a significant share of a foreign excluded fund or otherwise has a significant enough control relationship with such a fund, the fund may be deemed a subsidiary (or other affiliate) of the FBO. In that case, the fund will itself be a "banking entity" as defined in the Original Rule.[16] As a result, the fund will be directly subject to proprietary trading and other restrictions under the Volcker Rule. The Agencies have previously addressed this issue by publishing a policy statement that included time-limited no-action relief. The 2020 Revisions codify this relief, exempting "qualifying foreign excluded funds" from the Volcker Rule's proprietary trading prohibitions and restrictions on covered fund activities. The 2020 Revisions also clarify that a qualifying foreign excluded fund will not be required to have a Volcker Rule compliance program or satisfy certain additional reporting and other requirements.

A fund will qualify for the exemption if

- the fund is organized or established outside the United States and its ownership interests are offered and sold solely outside the United States

- the fund (i) would be a covered fund if it were organized or established in the United States or (ii) is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in financial instruments for resale or other disposition or otherwise trading in financial instruments

- the fund would not be a banking entity except by virtue of the acquisition or retention of an ownership interest in, the sponsorship of, or a relationship with the fund, by another banking entity

    - that is not organized, or directly or indirectly controlled by a banking entity that is organized, under the laws of the United States or of any state and

    - whose acquisition or retention of an ownership interest in or sponsorship of the fund meets the requirements for permitted covered fund activities and investments solely outside the United States (the so-called SOTUS exemption)

- the fund is established and operated as part of a bona fide asset management business and

- the fund is not operated in a manner that enables the banking entity that sponsors or controls the qualifying foreign excluded fund, or any of its affiliates, to evade the requirements of the Volcker Rule

Relaxing the Original Rule's Super 23A Restrictions

The Original Rule placed restrictions (so-called "Super 23A" restrictions) on a banking entity's ability to enter into certain "covered transactions" with covered funds for which the banking entity serves, directly or indirectly, as the investment manager, investment adviser, commodity trading adviser, or sponsor or that the banking entity otherwise organizes and offers. The Super 23A restrictions are based on Section 23A of the Federal Reserve Act (which restricts the transactions that an FDIC-insured depository institution may enter into with its affiliates). However, the Original Rule's Super 23A restrictions did not incorporate any of the exemptions provided for in the Federal Reserve Board's regulations implementing the ordinary 23A restrictions. Thus, for example, even though a bank may provide intraday credit to its affiliates (subject to certain conditions), a banking entity could not do the same with respect to a covered fund that it sponsors.

The 2020 Revisions will expand the exemptions to the Super 23A restrictions so they align with those under certain provisions of the Federal Reserve Act's Regulation W, which implements Section 23A of the Federal Reserve Act.

The 2020 Revisions will permit "a banking entity to engage in certain covered transactions with a related covered fund that would be exempt from the quantitative limits, collateral requirements, and low-quality asset prohibition under section 23A of the Federal Reserve Act, including certain transactions that would be exempt pursuant to section 223.42 of the Board's Regulation W."[17] In addition, the 2020 Revisions will include independent exemptions permitting banking entities to acquire assets in connection with payment, clearing, and settlement services and to enter into qualifying riskless principal transactions with a covered fund.[18]

Parallel Investments

Section 11 of the Original Rule permits banking entities to organize and offer covered funds in certain circumstances. Section 12 of the Original Rule sets forth quantitative limitations on banking entities' ability to invest in the covered funds that they organize and offer.

When the Original Rule was adopted, the Agencies stated that "if a banking entity makes investments side by side in substantially the same positions as the covered fund, then the value of such investments shall be included for purposes of determining the value of the banking entity's investment in the covered fund."[19]

The Revised Rule will include a new Section 12(b)(5), setting forth a rule of construction that will permit banking entities to make parallel investments in many circumstances. The rule of construction will apply to any "any investment the banking entity makes alongside a covered fund as long as the investment is made in compliance with applicable laws and regulations, including applicable safety and soundness standards." The rule of construction states that with respect to any such investment, the banking entity (i) will not be required to include the investment in the calculation of the investment limits under Section 12 and (ii) will not be otherwise restricted under Section 12 in the amount of any such investment.

In commenting on the new rule of construction, the Agencies confirmed that

> a banking entity could market a covered fund it organizes and offers pursuant to § __.11 on the basis of the banking entity's expectation that it would invest in parallel with the covered fund in some or all of the same investments, or the expectation that the banking entity would fund one or more co-investment opportunities made available by the covered fund.[20]

Limited Changes Made by the 2019 Revisions to Covered Fund Restrictions

The 2019 Revisions made a limited number of changes to the covered fund restrictions. Those earlier changes were not affected by the 2020 Revisions.

Underwriting, Market Making, and Hedging Related to Covered Funds

Hedging. The 2019 Revisions permit banking entities to acquire ownership interests in covered funds "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."[21] The 2019 Revisions require that any such hedge be for a "transaction conducted solely to accommodate a specific customer request with respect to the covered fund."[22] Thus, banking entities will again be able to offer structured products that are linked to covered funds and to engage in certain other customer-oriented activities in which banking entities engaged before the Original Rule was adopted.

Underwriting and market making. The Original Rule imposed limitations on a banking entity when the banking entity acquired ownership interests in covered funds in the course of underwriting or making a market in such ownership interests.

Some of the Original Rule's ownership interest limitations apply only if the banking entity also sponsors, advises, or organizes and offers the covered fund in question; such limitations apply on a *covered-fund-by-covered-fund basis*. Other limitations apply in the case of a banking entity's underwriting and market making with respect to any covered fund; such limitations apply on an *aggregate basis* to all holdings of ownership interests in all covered funds.

The 2019 Revisions restricted the application of the aggregate limitations. Such limitations will apply only where a banking entity (i) underwrites or makes a market in ownership interests of a covered fund and (ii) sponsors, advises, or organizes the covered fund.

SOTUS: Covered Fund Activities Outside the United States

The SOTUS exemption in the Original Rule allows non-U.S. banking entities to engage in certain covered fund activities outside of the United States. The 2019 Revisions made some key changes to the SOTUS exemption.

First, the 2019 Revisions incorporated, in substance, a response to an FAQ that the Agencies' staffs published in

2015. That response clarified that the SOTUS "marketing restriction" — the requirement that covered fund ownership interests not be offered or sold to U.S. residents — applies only where the banking entity that wishes to rely on the SOTUS exemption participates in related offer and sale activity.[23] Thus, an FBO that is only an investor in a covered fund may rely on the SOTUS exemption even if the fund's securities are otherwise offered and sold in the United States.[24] However, the 2019 Revisions, like the FAQ response, states that a banking entity will be deemed to participate in the offer and sale activity of a covered fund — and thus will not qualify for the SOTUS exemption — if it (or an affiliate) sponsors or serves, directly or indirectly, as the investment manager, investment adviser, commodity pool operator, or commodity trading adviser to the covered fund.

Second, the 2019 Revisions eliminated the SOTUS condition requiring that no financing for the banking entity's ownership or sponsorship may be provided, directly or indirectly, by any branch or affiliate located in the United States or organized under the laws of the United States or of any state.

Super 23A Restrictions and Covered Funds

As discussed above, the Original Rule's Super 23A restrictions limited the ability of a banking entity to enter into certain transactions with certain covered funds, including those covered funds for which the banking entity serves as the investment manager, investment adviser, commodity trading adviser, or sponsor.

The 2019 Revisions made only one minor change to the Super 23A restrictions (related to the timing of an officer certification for the prime brokerage exception to those restrictions, which is consistent with guidance that the Agencies' staffs have previously provided). As discussed, the 2020 Revisions made more significant changes to the Super 23A restrictions.

Key Changes Made by the 2019 Revisions

The key changes made by the 2019 Revisions are:

- incorporation of a new three-tier categorization of banking entities, based on whether their trading assets and liabilities are "significant," "moderate," or "limited"
- elimination of almost all of the "enhanced minimum standards" for compliance programs set forth in Appendix B of the Original Rule
- expansion of the scope of several exclusions and exemptions related to the proprietary trading restrictions, including (i) the liquidity management exclusion, (ii) the underwriting and market-making exemptions, (iii) the risk-mitigating hedging exemption, and (iv) the trading activities outside the U.S. (TOTUS) exemption
- addition of exclusions for (i) error trades, (ii) certain customer-driven swaps (or security-based swaps) and matched swaps (or security-based swaps), and (iii) purchases and sales of financial instruments that do not meet the definition of "trading assets" or "trading liability" under applicable reporting forms
- modification of the trading account definition and the 60-day presumption

Banking Entity Categories

The 2019 Revisions divided banking entities into three categories based on the levels of their trading assets and liabilities. Those categories are used to tailor requirements in several sections of the Revised Rule, including the compliance program requirements.

A banking entity's category will be determined, as of a given date, by the average gross sum of its trading assets and liabilities (together with those of its subsidiaries and other affiliates) over the prior consecutive four quarters (measured as of the last day of each quarter). The categories and thresholds are:

- significant trading assets and liabilities: $20 billion or more[25]
- moderate trading assets and liabilities: $1 billion or more (but less than $20 billion)
- limited trading assets and liabilities: less than $1 billion

For U.S. banking organizations, trading assets and liabilities will be measured on a worldwide basis. In contrast, an FBO will measure only the trading assets and liabilities of the combined U.S. operations of the FBO's top-tier entity (including all subsidiaries, affiliates, branches, and agencies of the FBO operating, located, or organized in the United States).

In calculating trading assets and liabilities, banking entities may exclude trading assets and liabilities attributable to U.S. government securities and U.S. federal agency securities. (The Revised Rule, like the Original Rule, provides an exemption from its restrictions on proprietary trading for such securities.)

Some commenters requested changes to the Original Rule to clarify how trading assets and liabilities are calculated generally. The Agencies declined to make any related changes. However, they suggested that banking entities will be able to leverage existing forms of regulatory reporting "such as the Form Y9-C and the Call Report" when measuring trading assets and liabilities for purposes of determining their Volcker Rule category.

The Agencies may, by following a prescribed regulatory notice and response procedure, recategorize a banking entity that would otherwise be categorized as having limited or moderate trading assets and liabilities.

Revisions With Respect to Proprietary Trading Restrictions

Definition of "Trading Account"

The definition of "trading account" determines the scope of the proprietary trading prohibition.[26] The 2019 Revisions largely retained the three prongs of the Original Rule's trading account definition: (i) the short-term intent prong, (ii) the market risk capital rule prong, and (iii) the dealer prong. However, the 2019 Revisions made two important changes to the "trading account" definition to clarify the definition's application to particular trades and reduce the related compliance burden:

Reversal of the 60-day presumption related to the short-term intent prong. The Original Rule included a 60-day rebuttable presumption: A purchase or sale of a financial instrument was presumed to be covered by the short-term intent prong of the "trading account" definition if the banking entity held the instrument for *fewer than 60 days* (or substantially transferred the risk of the position *within 60 days*). The 2019 Revisions reversed that presumption: Positions that are held for *60 days or more* will be presumed *not* to be for short-term purposes, unless the relevant Agency rebuts the presumption. Thus, whenever a banking entity holds financial instruments (or related risk positions) for fewer than 60 days, the banking entity will need to evaluate whether its trading of such instruments is for any of the short-term purposes targeted by the short-term intent prong (but only if the banking entity is subject to the short-term intent prong at all — see discussion immediately below), but it will not be presumed to be for short-term purposes.

Market risk capital rule prong and related opt-in. The 2019 Revisions will not apply the first prong of the "trading account" definition — the short-term intent prong — to any banking entity that is subject to the second prong of the definition — the market risk capital rule prong. A banking entity is subject to the second prong if it (or a consolidated affiliate) calculates risk-based capital ratios under the Agencies' market risk capital rule. The market risk capital rule prong covers any account used by such a banking entity to purchase or sell financial instruments that are both market risk capital rule covered positions and trading positions (or hedges of other market risk capital rule covered positions) for purposes of the market risk capital rule.

The 2019 Revisions also allowed banking entities that are not automatically subject to the market risk capital rule prong (as described above) to elect to comply with that prong in lieu of the short-term intent prong. Such election must be made by the banking entity and all of its wholly owned subsidiaries or not at all. The opt-in will be helpful to a variety of banking entities, including those non-U.S. banking entities that may be subject to the market risk capital rule in their home countries but not in the United States.[27]

Exclusions From Proprietary Trading

Liquidity management exclusion. The 2019 Revisions expanded the range of liquidity management activities excluded from restrictions on proprietary trading. The Original Rule excluded only the purchase and sale of *securities* for liquidity management purposes. The 2019 Revisions expanded the exclusion for liquidity management activities involving the purchase and sale of foreign exchange forwards, foreign exchange swaps, and cross-currency swaps (in addition to purchases and sales of securities), assuming that the transactions meet the other conditions of the liquidity management exclusion.

Error trades. The Agencies acknowledged in the 2018 Rule Proposal that, on occasion, banking entities erroneously purchase or sell financial instruments in the course of conducting otherwise permissible activities. Thus, the 2019 Revisions included a new exclusion from the definition of proprietary trading for error trades and subsequent correcting transactions. The 2019 Revisions did not include the 2018 Rule Proposal's related requirement that once an error trade is recognized, the financial instruments acquired in error should be transferred to a separately managed trade error account for resolution.

Matched derivative transactions. The 2019 Revisions excluded from the definition of "proprietary trading" the execution of certain customer-driven swaps (or security-based swaps) together with the execution of matched swaps (or security-based swaps) that offset them. The Agencies stated in the 2019 Adopting Release that they were adopting the additional exclusion to provide greater certainty for banking entities that are not dealers but that engage in relevant customer-driven matched-book swap transactions (e.g., in connection with the banking entity's commercial lending activities). Thus, to qualify for the exclusion, the banking entity (i) must enter into the customer-driven swap or security-based swap and the matched swap or security-based swap contemporaneously, (ii) may retain no more than minimal price risk, and (iii) may not be a registered dealer, swap dealer, or security-based swap dealer.

Definition of "Trading Desk"

The 2019 Revisions amended the definition of "trading desk," which now has two prongs. The first prong significantly modifies the Original Rule's definition of "trading desk." The second prong is entirely new and applies to banking entities that calculate risk-based capital ratios under the Agencies' market risk capital rule.[28] The Agencies believe that the Revised Rule's new "trading desk" definition "will ensure that banking entities that are subject to the market risk capital prong and banking entities that are not subject to the market risk capital prong have comparable trading desk definitions."[29]

Underwriting and Market-Making Exemptions

The 2019 Revisions made two largely parallel sets of changes to two exemptions from the proprietary trading prohibition: one exemption related to underwriting and one related to market-making. One set of changes is designed to simplify the compliance program burdens for certain banking entities relying on those exemptions; the applicability of such changes depends on the level of a banking entity's trading assets and liabilities. The other set of changes is designed to facilitate application of a condition that is common to both exemptions; those changes relate to a banking entity's reasonably expected near-term demands of clients, customers, or counterparties of the banking entity (RENTD).

Reduced compliance burdens for certain banking entities. Under the Original Rule, the underwriting and market-making exemptions were both conditioned on a banking entity's maintaining a compliance program reasonably designed to satisfy the requirements of the relevant exemption. Following the 2019 Revisions, that condition will continue to apply only to banking entities with significant trading assets and liabilities. Other banking entities will be relieved of the exemption-specific compliance program requirements.

However, because such other banking entities will need to ensure compliance with the exemptions' remaining conditions (if the exemptions are relied on), those banking entities will, in practice, likely maintain some type of related compliance program. In that regard, the Agencies noted that the Revised Rule "should provide [such] banking entities with additional flexibility to tailor their compliance programs in a way that takes into account the risk profile and relevant trading activities of each particular trading desk."[30]

RENTD: reliance on internal risk limits. The 2019 Revisions provided an alternative means of satisfying the RENTD condition for the underwriting and market-making exemptions. If the banking entity establishes and enforces internal risk limits at each trading desk that are designed to prevent the trading desk from exceeding RENTD (and meet certain related conditions), there will be a presumption that the banking entity complies with the RENTD condition in connection with related underwriting and market-making-related activities. The internal risk limits must address specific criteria (which differ to some extent for the underwriting and market-making exemptions), and there are specific recordkeeping (but not reporting) requirements related to breaches of the internal risk limits. The 2019 Revisions also set forth a mechanism that an Agency must follow if it seeks to rebut the presumption of compliance.

Risk-Mitigating Hedging Exemption

The 2019 Revisions amended certain aspects of the Original Rule's exemption for risk-mitigating hedging. Most significant are two changes designed for all banking entities that rely on the exemption:

- elimination of the correlation analysis requirement of the Original Rule's hedging exemption (i.e., the requirement to complete a correlation analysis that demonstrates that their hedging activity demonstrably reduces or mitigates the specific risks being hedged)
- elimination of the requirement that banking entities continually show that hedges "demonstrably" reduce or otherwise significantly mitigate particular risks. Hedges must nonetheless be "designed" to reduce or otherwise significantly mitigate particular risks and be recalibrated on an ongoing basis

The 2019 Revisions made additional changes to the hedging exemption, but their applicability depends on the level of trading assets and liabilities of the banking entity seeking to rely on the exemption. Thus, for banking entities that do not have significant trading assets and liabilities, the 2019 Revisions made three additional changes:

- elimination of the requirement for a separate internal compliance program related specifically to the hedging exemption (similar to the elimination of requirements for exemption-specific compliance programs for the underwriting and market-making exemptions)
- elimination of the restrictions on compensation arrangements for employees who perform hedging activities and
- elimination of the additional documentation requirements for hedging activities involving other trading desks or instruments or strategies not contemplated by the policies and procedures of the trading desk

For banking entities with significant trading assets and liabilities, the 2019 Revisions reduced, but did not eliminate, the documentation requirements related to hedging activities involving other trading desks of the banking entity or instruments or strategies not contemplated by the policies and procedures of the trading desk.

TOTUS: Trading Activity Outside the United States

The Original Rule provided the TOTUS exemption for non-U.S. banking entities engaged in certain trading activities outside of the United States. The 2019 Revisions broadened the exemption's application by modifying one of its conditions and eliminating two others:

- It modified the requirement that personnel of the banking entity (or its affiliates) who arrange, negotiate, or execute a given transaction not be located in the United States. That condition will now address only "the decision to purchase or sell as principal," thus permitting some involvement by U.S. personnel of the banking entity (or its affiliates) in the arrangement, negotiation, and execution of exempt trades.
- It eliminated the requirement that no financing for a purchase or sale be provided by any U.S. branch or affiliate of the banking entity. However, the principal risk of the transaction must continue to be required to be booked and accounted for outside the United States.

- It eliminated the requirement that transactions not being conducted "with or through" any U.S. entity. This change resolves complicated questions regarding its application, particularly whether certain transactions with or through U.S. entities qualify for an exception to the prohibition. Specifically, the Agencies confirmed that

> the foreign trading exemption [will] not preclude a foreign banking entity from engaging a non-affiliated U.S. investment adviser as long as the actions and decisions of the banking entity as principal occur outside of the United States.[31]

Revisions to Compliance Program Requirements and Metrics Reporting

The 2019 Revisions simplified the compliance reporting requirements for all banking entities. The 2019 Revisions eliminated almost all of the "enhanced minimum standards" of the Original Rule's Appendix B and made a number of detailed changes to the metrics reporting requirements (set forth in the Original Rule's Appendix A) for the limited number of banking entities that must report those metrics.

Compliance Program Requirements

The three different categories of banking entities are subject to the following different compliance program requirements.

Banking entities with significant trading assets and liabilities. Each such banking entity will be required to maintain a compliance program that satisfies (i) the "six-pillar" requirements of the Original Rule,[32] (ii) the covered fund documentation requirements of the Original Rule, and (iii) the CEO attestation requirement of the Original Rule's Appendix B. However, Appendix B itself and the balance of its "enhanced minimum standards" — which elaborated on and set minimum detailed requirements related to the "six pillars" — have been eliminated. As described below, such banking entities will also be subject to a revised form of metrics reporting.

Banking entities with moderate trading assets and liabilities. Each such banking entity will be required to establish a "simplified compliance program" in the manner prescribed previously by Section 20(f)(2) of the Original Rule. In a change from the 2018 Rule Proposal, such banking entities will not be subject to the CEO attestation requirement described above (which, following the 2019 Revisions, will apply solely to banking entities with significant trading assets and liabilities). Thus, a banking entity in this category will meet its compliance program requirements if it includes in its existing compliance policies and procedures references to the requirements of the Volcker Rule statutory provisions (Section 13 of the BHCA) and the implementing regulations.

Banking entities with limited trading assets and liabilities. Each such banking entity will be presumed to be in compliance with the Volcker Rule and will have no obligation to demonstrate compliance on an ongoing basis (although it must still comply with the substance of the Revised Rule as otherwise applicable). Citing the 2018 Rule Proposal, the Agencies explained:

> Under the proposed approach, the agencies would not have expected a banking entity with limited trading assets and liabilities that qualified for the presumption of compliance to demonstrate compliance with the proposal on an ongoing basis in conjunction with the agencies' normal supervisory and examination processes. However, the appropriate agency would have been able to exercise its authority to treat the banking entity as if it did not have limited trading assets and liabilities if, upon review of the banking entity's activities, the relevant agency determined that the banking entity engaged in proprietary trading or covered fund activities that were otherwise prohibited under subpart B or subpart C.[33]

Metrics Reporting

Section 20(d) of the Original Rule required the largest banking entities to report quantitative trading information in significant detail, as described in the Original Rule's Appendix A. The 2019 Revisions retained Section 20(d), but that section will apply only to banking entities with significant trading assets and liabilities (the threshold for which is higher than the analogous threshold that applied under Section 20(d) of the Original Rule). In addition, the 2019 Revisions made significant changes to Appendix A with respect to the metrics that must be reported.

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[1] The Agencies are the Board of Governors of the Federal Reserve System (the Federal Reserve Board), the Office of the Comptroller of the Currency (the OCC), the Federal Deposit Insurance Corporation (the FDIC), the Securities and Exchange Commission (the SEC), and the Commodity Futures Trading Commission (the CFTC).
The Volcker Rule statutory requirements are set forth in Section 13 of the Bank Holding Company Act of 1956, as amended (the BHCA), which was added to the BHCA by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

[2] See Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432 (July 17, 2018) (the 2018 Rule Proposal), available at https://www.govinfo.gov/content/pkg/FR-2018-07-17/pdf/2018-13502.pdf; Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 85 Fed. Reg. 12120 (February 28, 2020) (the 2020 Rule Proposal), available at https://www.govinfo.gov/content/pkg/FR-2020-02-28/pdf/2020-02707.pdf.

[3] The Agencies published lengthy supplementary information when they adopted the original regulations. See 79 Fed. Reg. 5536 (Jan. 31, 2014) (Federal Reserve Board, FDIC, OCC and SEC), available at https://www.govinfo.gov/content/pkg/FR-2014-01-31/pdf/2013-31511.pdf; 79 Fed. Reg. 5808 (Jan. 31, 2014) (CFTC), available at: https://www.govinfo.gov/content/pkg/FR-2014-01-31/pdf/2013-31476.pdf.

[4] See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 84 Fed. Reg. 61974 (Nov. 14, 2019) (the 2019 Adopting Release), available at https://www.govinfo.gov/content/pkg/FR-2019-11-14/pdf/2019-22695.pdf.

[5] See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, Final Rule (June 25, 2020) (the 2020 Adopting Release), available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200625a1.pdf.

[6] Those amendments followed other changes to the Volcker Rule within the past two years, including the implementation of an exemption for smaller banking organizations (e.g., community banks) and a liberalization of the name-sharing restrictions of the Volcker Rule, which were adopted in July 2019 substantially in the form proposed in 2018. See Sidley Update, "Volcker Rule: Agencies Propose to Implement Community Bank Exemption and Revised Name-Sharing Rule" (December 21, 2018), available at https://www.sidley.com/en/insights/newsupdates/2018/12/volcker-rule-agencies-propose-to-implement-community-bank-exemption-and-revised-name-sharing-rule. The changes were made in response to a statutory change made earlier in 2018. See Sidley Update, "President Trump Signs Financial Services Regulatory Reform Legislation" (May 29, 2018), available at https://www.sidley.com/en/insights/newsupdates/2018/05/president-trump-signs-financial-

services-regulatory-reform.
In addition, the Federal Reserve Board recently amended its definition of "control," which plays a key role in the Volcker Rule's definition of "banking entity." See Sidley Update, "Federal Reserve Issues Final Rule Interpreting 'Control'" (February 10, 2020), available at https://www.sidley.com/en/insights/newsupdates/2020/02/federal-reserve-issues-final-rule-interpreting-control.

[7] Original Rule, Section 10(d)(6).

[8] 2020 Rule Proposal at 12148 (Question 78).

[9] 2020 Adopting Release at 154.

[10] Both kinds of issuer are permitted (i) to own certain kinds of servicing assets and assets that are incidental or related to their other assets and (ii) to enter into certain derivative transactions for purpose of reducing interest rate and foreign exchange risks. See Revised Rule, Sections 10(c)(8)(i)(B), 10(c)(8)(i)(C), 10(c)(15)(i)(C), and 10(c)(15)(i)(D).

[11] 2020 Adopting Release at 91-92 (describing SEC Rule 203(l)-1, adopted pursuant to the Investment Advisers Act of 1940).

[12] *Id.* at 124.

[13] *Id.* at 24.

[14] 2020 Rule Proposal at 12126.

[15] BHCA, Section 13(g)(2).

[16] The Original Rule's definition of "banking entity" was not changed by the 2019 Revisions or the 2020 Revisions. It covers not only a broad range of FBOs but also their "affiliates" and "subsidiaries" (as the BHCA defines those terms). Although covered funds are generally excluded from the definition of "banking entity," foreign excluded funds are not covered funds in the first place and thus are not excluded from the "banking entity" definition.

[17] 2020 Adopting Release at 136.

[18] See *id.* at 139-40.

[19] *Id*. at 160 (quoting the adopting release for the Original Rule).

[20] *Id*. at 164.

[21] Revised Rule, Section 13(a)(1)(ii).

[22] Revised Rule, Section 13(a)(2)(ii)(B)(1).

[23] See Sidley Update, "Volcker Rule: Clarification of Covered Fund 'SOTUS' Exemption" (March 3, 2015), available at https://www.sidley.com/en/insights/newsupdates/2015/03/volcker-rule-clarification.

[24] The other change eliminates the Original Rule's SOTUS condition requiring that no financing for the banking entity's permitted ownership or sponsorship may be provided, directly or indirectly, by any branch or affiliate located in the United States or organized under the laws of the United States or of any state.

[25] The $20 billion threshold reflects an increase from the $10 billion threshold included in the 2018 Rule Proposal.

[26] In Section 3(a), the Revised Rule (like the Original Rule) defines "proprietary trading" as "engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments."

[27] The 2018 Rule Proposal considered expanding the market risk capital prong to cover non-U.S. banking entities that are subject to home-country capital requirements under a market risk framework that is consistent with the framework published by the Basel Committee on Banking Supervision, but the 2019 Revisions ultimately did not adopt that position.

[28] Section 3(e)(14) of the Revised Rule defines "trading desk" as

> a unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof that is:
>
> (i) (A) Structured by the banking entity to implement a well-defined business strategy; (B) Organized to ensure appropriate setting, monitoring, and management review of the desk's trading and hedging limits, current and potential future loss exposures, and strategies; and (C) Characterized by a clearly defined unit that: (1) Engages in coordinated trading activity with a unified approach to its key elements; (2) Operates subject to a common and calibrated set of risk metrics, risk levels, and joint trading limits; (3) Submits compliance reports and other information as a unit for monitoring by management; and (4) Books its trades together; or
>
> (ii) For a banking entity that calculates risk-based capital ratios under the market risk capital rule, or a consolidated affiliate for regulatory reporting purposes of a banking entity that calculates risk-based capital ratios under the market risk capital rule, established by the banking entity or its affiliate for purposes of market risk capital calculations under the market risk capital rule.

[29] 2019 Adopting Release at 61997.

[30] *Id.* at 62006.

[31] *Id.* at 62016.

[32] "The six elements specified in §20(b) are:

- Written policies and procedures reasonably designed to document, describe, monitor, and limit trading activities and covered fund activities and investments conducted by the banking entity to ensure that all activities and investments that are subject to section 13 of the BHC [Bank Holding Company] Act and the rule comply with section 13 of the BHC Act and the 2013 rule;

- A system of internal controls reasonably designed to monitor compliance with section 13 of the BHC Act and the rule and to prevent the occurrence of activities or investments that are prohibited by section 13 of the BHC Act and the 2013 rule;
- A management framework that clearly delineates responsibility and accountability for compliance with section 13 of the BHC Act and the 2013 rule and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation, and other matters identified in the rule or by management as requiring attention;
- Independent testing and audit of the effectiveness of the compliance program conducted periodically by qualified personnel of the banking entity or by a qualified outside party;
- Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and
- Records sufficient to demonstrate compliance with section 13 of the BHC Act and the 2013 rule, which a banking entity must promptly provide to the relevant agency upon request and retain for a period of no less than 5 years."

2019 Adopting Release at 62022.

[33] *Id.* at 62024.