CLEARY GOTTLIEB

ALERT MEMORANDUM

Volcker 1.5: Highlights of Proposal to Simplify the Volcker Rule

May 31, 2018

Yesterday, the Federal Reserve Board approved a 373-page notice of proposed rulemaking that represents a first step toward simplifying and clarifying the Volcker Rule. The other four agencies responsible for implementation are expected to approve the notice in the coming days. Below is a brief summary of the key headlines and proposals from the release.

Headlines

- Significant revisions proposed on the proprietary trading restrictions—not just adjustments on the margins. Not surprisingly, the most meaningful change is the removal of the "purpose" test and the 60-day rebuttable presumption, although the scope of the new proposed "accounting" prong for trading accounts is potentially broader than the purpose test it is replacing. The proposed "presumption of compliance" for certain desks brought in by the accounting prong may be difficult to monitor and implement.
- No revisions to the definition of covered funds, but the proposal would provide significantly greater flexibility to acquire covered fund interests in reliance on the market making, underwriting and hedging exemptions, including in the fund-linked products space.
- Banking organizations are divided into three tiers based on size of trading assets and liabilities, with reduced compliance program and recordkeeping requirements for those in lower tiers.
- Clear intent to increase flexibility of compliance program requirements and tailor metrics reporting, especially for banking organizations in the lower tiers, but unclear whether, in practice, the largest banks will see much relief and the lower tier banks will find the intended burden reductions effective. CEO attestation remains for most banks.
- Beyond the changes proposed, the agencies have raised a multitude of questions for comment, including questions highlighting concerns raised by industry, creating opportunities to continue to inform the rulemaking process with well-founded arguments and factually supported comments.

Proprietary Trading Proposed Revisions

- Replaces the intent-based purpose test of the proprietary trading definition and the 60-day rebuttable presumption with a new accounting prong that captures positions recorded at fair value on a recurring basis, which the agencies believe would cover derivatives, trading securities and AFS securities. The accounting prong, while apparently intended to provide greater clarity and predictability, is likely to create significant questions of scope and application.

- The market risk capital test and dealer test would remain, as would lingering interpretive issues around the scope of the dealer test.

- Trading desks that are subject only to the accounting prong (and not also to the market risk capital and/or dealer prongs) can benefit from a new presumption of compliance with the proprietary trading restrictions if they continue to meet a profit/loss threshold. On a rolling 90-day look-back basis, the absolute value of net realized and unrealized gains or losses for the desk's portfolio would need to remain below $25 million. The introduction of this dollar-based threshold will raise issues regarding monitoring and "springing" compliance obligations if the threshold is crossed, and may put additional focus on the definition of trading desks.

- Expands the liquidity management exclusion beyond just securities to also permit FX forwards, swaps and physically-settled cross-currency swaps, addressing a widely held industry concern with the liquidity management exclusion in the final rule.

- Compliance with RENTD under the market-making and underwriting exemptions would be presumed if the banking entity maintains and enforces internal risk limits for each trading desk, further evidencing the proposal's shift toward managing risk rather than managing transactions and transaction intent.

- On the hedging exemption, removes the requirements for correlation analysis and showing that the hedge "demonstrably reduces or otherwise significantly mitigates" an identifiable risk.

    - For organizations with under $10 billion in trading assets and liabilities, requirements of the hedging exemption are further simplified as long as the hedge is "designed" at inception to reduce or otherwise significantly mitigate an identifiable risk and it is subject to ongoing recalibration.

    - Although organizations with $10 billion or more in trading assets and liabilities may be subject to enhanced documentation requirements for certain hedging activities, these enhanced requirements can be alleviated if the hedges are commonly used by the desk and are within established risk limits.

Covered Fund Proposed Revisions

- No proposed changes to the covered fund definition, but requests comment on a number of important revisions—for example, whether to adopt a characteristics-based definition of covered fund and whether to revisit the conditions of various exclusions from the covered fund definition, including those for foreign public funds, securitizations, family wealth management vehicles, joint ventures and other issuers.

- Increases the utility of the underwriting and market-making exemptions by removing the requirement to count interests in third-party covered funds acquired under those exemptions towards the aggregate 3% limit and the capital deduction.
- Restores the exemption from the 2011 proposed rule that would permit a banking entity to hold a covered fund interest as a risk-mitigating hedge when acting as an intermediary on behalf of a customer to facilitate the customer's exposure to the fund. This change mitigates the controversial "high-risk trading strategy" guidance that severely limited fund-linked products businesses.
- Solicits comment on the "Super 23A" prohibition, including whether the exemptions of regular 23A should be incorporated; adopts CFTC's position permitting banking entities to provide FCM clearing services to related covered funds.

Key Foreign Bank Issues

- Removes several conditions from the "trading outside the United States" or TOTUS exemption, including (i) the prohibition against the purchase or sale being conducted with or through a U.S. entity, (ii) the prohibition against provision of financing for the transaction by any U.S. branch or entity and (iii) the requirement that no U.S. personnel be involved in arranging, negotiating or executing the transaction. Instead, the revised rule would focus on principal risk and actions remaining outside the United States.
- Does not provide a permanent fix to the banking entity problem for controlled foreign excluded funds, but extends to July 2019 the current no-action relief set to expire in July 2018.
- Incorporates into the regulation the relief in FAQ #13 for investments by foreign banks under the SOTUS exemption in third-party funds sold into the United States.

Compliance Program, Attestation and Metrics

- Creates three categories of banking entities based on the size of gross trading assets and liabilities ($10 billion and above, between $10 billion and $1 billion, and under $1 billion). According to Board staff, approximately 40 firms have $1 billion or more in trading assets and liabilities, accounting for 98% of U.S. trading activity, and only 18 are over $10 billion.
    - Only firms with $10 billion or more in trading assets and liabilities would be required to implement the full "six-pillar" compliance program and metrics reporting regime.
    - Firms between $1 billion and $10 billion would be required to implement a simplified program by incorporating Volcker Rule compliance into existing policies and procedures.
    - Firms with less than $1 billion would benefit from a "presumption of compliance" with "no obligation to demonstrate compliance on an ongoing basis". However, if a supervisor determined that such a banking entity was engaged in prohibited trading or covered fund activity, it could force the banking entity to remediate the activity and/or implement a compliance program.

  - For foreign banks, the $10 billion threshold is measured by reference to the foreign bank's combined U.S. operations, but the $1 billion threshold would be measured on a global basis.
- Eliminates the highly prescriptive "enhanced compliance program" that had applied to banking organizations with more than $50 billion in total consolidated assets or more than $10 billion in trading assets and revenues in favor of increased flexibility, with the expectation banks will tailor their programs to their size, scope and complexity.
- CEO attestation will be required for banking entities with more than $1 billion in trading assets and liabilities, which it seems could capture some banking entities with less than $10 billion in trading assets and liabilities for the first time. Does not address long-pending questions regarding how many CEO attestations are required for a banking organizations with multiple subsidiaries (or, in the case of foreign banks, US branches and subsidiaries).
- Retains metrics reporting, but with significant changes meant to simplify compliance and allow for more efficient data collection.

Agency Coordination

- Solicits comments on better coordination but does not propose a lead agency or other changes to the interagency rulemaking process or enforcement.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

Derek M. Bush
+1 202 974 1526
dbush@cgsh.com

Katherine M. Carroll
+1 202 974 1584
kcarroll@cgsh.com

Hugh C. Conroy Jr.
+1 212 225 2828
hconroy@cgsh.com

Michael H. Krimminger
+1 202 974 1720
mkrimminger@cgsh.com

Colin D. Lloyd
+1 212 225 2809
clloyd@cgsh.com

Michael A. Mazzuchi
+1 202 974 1572
mmazzuchi@cgsh.com

Jack Murphy
+1 202 974 1580
jmurphy@cgsh.com

Allison H. Breault
+1 202 974 1532
abreault@cgsh.com

Patrick Fuller
+1 202 974 1534
pfuller@cgsh.com

Alexander Young-Anglim
+1 212 225 2917
ayounganglim@cgsh.com