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ALERT MEMORANDUM

Volcker Rule "1.5":

Analysis of Key Proposed Changes and Considerations for Comments to the Agencies

June 19, 2018

On June 5, 2018, the five Volcker Rule regulatory Agencies announced publication of a Proposal to modify the "Volcker Rule".

In a statement accompanying the Federal Reserve Board's approval of the Proposal, Vice Chairman for Supervision Quarles suggested future changes to the Volcker Rule may be contemplated, by describing the Proposal as "our best first effort at simplifying and tailoring" the existing Volcker Rule regulations, and as "an important milestone in comprehensive Volcker [R]ule reform, but not the completion of our work".

Consistent with Governor Quarles' observations, the Agencies have proposed a number of meaningful revisions to the Volcker Rule's proprietary trading and covered fund restrictions, accompanied by numerous questions about potential modifications (particularly in the case of covered fund activities and investments).

The overall tone and approach of the Proposal reflects an interest among the Agencies in implementing practical revisions to the 2013 Final Rule that will reduce "ambiguity, overbroad application, or unduly complex compliance routines". The proposed changes are intended to "simplify and tailor the implementing regulations . . . in order to increase efficiency, reduce excess demands on available compliance capacities at banking entities, and allow banking entities to more efficiently provide services to clients". At the same time, some elements of the Proposal, such as the new accounting prong of the trading account definition and new notice and filing requirements, could increase the scope of the trading prohibition and compliance burdens on banking entities.

The many questions asked throughout the Proposal appear designed to support the Agencies' ability to introduce additional flexibility in any final rule in a manner consistent with the Administrative Procedure Act.

The Agencies also noted the enactment of the Economic Growth, Regulatory Reform, and Consumer Protection Act on May 24, 2018, stating that they plan to address the statute's amendments to the Volcker Rule through a separate rulemaking process. In the meantime, the Agencies indicated that they will not enforce the Volcker Rule in a manner inconsistent with the Act.

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This Alert offers further in-depth analysis of the Proposal, building on our initial key takeaways available here, and highlights areas of likely interest to commenters. A blackline showing the proposed revision to the 2013 Final Rule text is also available here.

The Alert (i) summarizes the key proposed modifications set forth in the Proposal[1] and selected requests by the Agencies[2] for industry comment, and (ii) offers our "Observations" analyzing key implications of the Proposal for the industry, including specific interpretive issues and questions presented that the industry will want to consider in developing comments on the Proposal.

Comments are due within 60 days of publication of the Proposal in the Federal Register, which is expected shortly. Given the number of questions presented for comment in the Proposal and the importance for the industry and regulators alike of an effective reappraisal of the Volcker Rule, it would not be surprising if the comment period were extended.

1 "Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds" (May 30, 2018), available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180530a1.pdf (the "Proposal"). Each Agency approved a version of the Proposal substantially identical to the version cited here.

2 The five "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").

I. Proprietary Trading — Proposed Changes, Questions and Observations

A. Definition of "Trading Account"

Summary of Proposed Changes:

- The Proposal would replace the **short-term intent-based purpose prong** and related **60-day rebuttable presumption** with a new **accounting prong**, capturing any purchase or sale of a financial instrument recorded at **fair value** on a **recurring basis** under applicable accounting standards.
  - The Agencies believe the accounting prong would generally capture but not be limited to **derivatives**, **trading securities** and **available-for-sale** ("AFS") **securities**.
  - This new prong would be subject to an out-of-scope presumption for certain trading desks, which we discuss below.
- The **market risk capital prong** and **dealer prong** of the trading account definition would remain.
  - The Proposal would modify the **market risk capital prong** to capture trading positions of foreign banking organizations ("FBOs") that are subject to home-country market risk capital requirements consistent with the Basel Committee's market risk framework.

Selected Questions Asked by the Agencies:

- Whether the proposed accounting prong:
  - Is overly broad.
  - Appropriately includes AFS securities and derivatives.
  - Should be revised to address practical, permissible expedients to fair value measurements that banking entities may use, such as for equity securities without a readily determinable fair value.
  - Would have an impact on the liquidity of corporate bonds or other securities, and what the impact would be.
  - Would expand or reduce the scope of trading activities currently captured within the trading account definition.

Observations:

- In its June 2017 report on regulation of the U.S. financial system,[3] the U.S. Treasury Department, consistent with the views of a number of market participants, recommended that the Agencies eliminate the subjective purpose test and 60-day rebuttable presumption to address ambiguities in and the perceived overbreadth of the restrictions on proprietary trading. However, the scope of positions in financial instruments subject to the proprietary trading restrictions under the proposed accounting prong is quite broad, and this new prong captures a number of positions in financial

[3] U.S. Department of the Treasury, "A Financial System that Creates Economic Opportunities: Banks and Credit Unions" (June 2017), at 74 (the "Treasury Report").

instruments and activities that, in many circumstances, had been objectively "out-of-scope", or determined by banking entities to be "out-of-scope", of the current Volcker Rule. This effect of the proposed accounting prong would appear to be ripe for industry comment. Commenters should provide specific examples of positions in financial instruments and activities that would be brought within the Volcker Rule "trading account" under the proposed accounting prong, with emphasis on those that were not intended to be captured in the original rule.

- Some examples of the over-inclusiveness of the proposed accounting prong include:
  - Under Accounting Standards Codification ("ASC") 320, Investments—Debt Securities, of the Financial Accounting Standards Board ("FASB"), debt securities are accounted for under one of three categories: "trading", AFS or "held to maturity" ("HTM"). Classification as trading or as HTM requires compliance with specific definitions, and these categories tend to be narrow. Classification as AFS requires only that the debt security not meet the definitions of trading or HTM. To illustrate:
    - Certain securities (such as convertible debt or interest-only strips) should not be classified as HTM even if they are long-term investments.
    - Securities classified as HTM may be required to be reclassified as AFS if the investing entity sells one or more securities or no longer has the ability to hold to maturity, notwithstanding the fact that the investment may still be a long-term investment. Once a portfolio is tainted with a sale, the remainder of the portfolio generally would need to be transferred to AFS.

    As these examples demonstrate, AFS classification can be quite broad and can encompass significant portfolios of debt securities held for investment purposes.
  - Under ASC 320-10-25-1, if a debt security is acquired with the intent of selling it within a short period of time, the security is classified as "trading". Use of this accounting definition would appear to be more consistent with the intent of the Volcker Rule as explained by the Agencies in the preamble to the 2013 final implementing regulations (the "2013 Final Rule"):

    > "To the extent that an overlap exists between the prongs of [the trading account] definition, the Agencies believe they are mutually reinforcing, strengthen the rule's effectiveness, and may help simplify the analysis of whether a purchase or sale is conducted for the trading account. The market risk capital prong . . . largely parallels the provisions of section 13(h)(4) of the BHC Act and mirrors the short-term trading account prong of both the proposed and final rules. . . . Incorporating this prong into the trading account definition reinforces the consistency between governance of the types of positions that banking entities identify as 'trading' for purposes of the market risk capital rules and those that are trading for purposes of the final rule under section 13 of the BHC Act".[4]

    To the extent that the proposed accounting prong is broader than the accounting "trading" definition, the Proposal appears inconsistent with these stated goals of the trading account prongs. Furthermore, the proposed accounting prong, by capturing both trading and AFS securities, is by definition broader than the purpose prong it would replace because of the congruity between the existing purpose prong and the accounting definition of "trading".

[4] "Proprietary Trading and Certain Interests in and Relationships with Covered Funds", 79 Fed. Reg. 5536, 5548 (Jan. 31, 2014).

- Under FASB Accounting Standards Update ("ASU") No. 2016-01 (Jan. 2016),[5] all equity securities are to be accounted for at fair value through current earnings unless the equity position (i) is an investment in a consolidated entity, (ii) is accounted for under the equity method (generally investments in 20% to 50% of the voting power of an entity) or (iii) lacks a readily determinable fair value (except upon the occurrence of an observable price change). Therefore, as another example of the breadth of the proposed accounting prong, a strategic non-equity-method investment in 15% of another company that has a readily determinable fair value (such as an investment in a company that has a partial public float) would appear to be captured by the proposed accounting prong because it is marked to fair value, notwithstanding its status as a long-term strategic investment.
- Under FASB ASC 815, derivatives are measured at fair value. Certain derivatives, such as those receiving cash flow hedge accounting treatment under ASC 815-35, may have been determined by banking entities to be out-of-scope under the existing Volcker Rule if the derivatives were associated with banking book investment positions. Under the proposed accounting prong, commenters should seek confirmation that any derivatives that receive special hedge accounting treatment under ASC 815 may be excluded, "safe harbored" or perhaps determined not to be recorded at fair value "on a recurring basis" if gains and losses do not run through current earnings.
- Pursuant to FASB ASC 940, Financial Services—Brokers and Dealers, broker-dealers are to account for both principal trading and principal investment positions as "securities owned" under the fair value method.[6] The proposed accounting prong could, therefore, capture all positions held by a broker-dealer, regardless of purpose. By contrast, under the dealer prong of the current rule, as clarified in both the preamble to the 2013 Final Rule and the preamble to the Proposal, the Agencies clearly state that a banking entity that is registered as a broker-dealer, swap dealer or security-based swap dealer need not include in the trading account investments in and other ownership of financial instruments that are not in connection with "activities that require the banking entity to be licensed or registered as" a dealer.[7]

▪ Use of the accounting prong is also likely to highlight differences among generally accepted accounting principles ("GAAP") in different jurisdictions. Furthermore, the Proposal is not clear whether the accounting treatment to be used for the proposed accounting prong should be based on the treatment of the asset in consolidation with a top-tier bank holding company, FBO or bank, or whether it should be based on the accounting treatment applied to local affiliates and branches. As an example of a difference related to fair value accounting, some jurisdictions do not have the "fair value option" concept found in FASB ASC 825-10.

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5 ASU 2016-01 was effective for public business entities on December 15, 2017. All other entities would apply ASU 2016-01 to annual financials after December 15, 2018 and to interim periods after December 15, 2019. See also FASB ASC 321, Investments – Equity Securities.

6 See FASB ASC 940-320-45-2; see also FASB ASC 940-320-30-2, 940-320-35-1.

7 See 2013 Final Rule, § __.3(b)(1)(iii)(A); 2013 Final Rule, 79 Fed. Reg. at 5549 ("In the case of both domestic and foreign entities, this provision applies only to financial instruments purchased or sold in connection with the activities that require the banking entity to be licensed or registered to engage in the business of dealing, which is not necessarily all of the activities of that banking entity") (emphasis in original); see also 2013 Final Rule, 79 Fed. Reg. at 5549 n. 135 and Proposal at n. 63.

- Based on the scope of the accounting prong, if adopted as proposed, it would appear that most banking entities would be required to (i) review business units that may not have been covered by the 2013 Final Rule for "trading desk" and "trading account" status, (ii) reconsider all prior out-of-scope determinations and (iii) consequently, revise or create compliance policies and procedures for newly captured positions or business units.
- Potential alternatives that commenters may wish to consider to address the over-inclusiveness of the proposed accounting prong could include:
  - Eliminating the accounting prong altogether.
  - Including only positions accounted for as "trading", although historical treatment of derivatives and recent elimination of classification of equity securities as trading or AFS under GAAP may require a different solution.
  - Linking the trading account definition to the proposed compliance tiers by including in the trading account only those entries in the "trading assets" or "trading liabilities" line items in appropriate reporting forms.[8]
  - Applying a form of the accounting prong only (i) to those top-tier banking entities that are not subject to the market risk capital / trading book rules under international capital guidelines and (ii) to any banking entity that does not meet the dealer prong.
- Without modification, it would appear that the breadth of the proposed accounting prong could potentially increase uncertainty regarding the availability of existing permitted activity exemptions, similar to the treatment of "loan-related swaps" discussed by the Agencies in the preamble to the Proposal.[9] In those scenarios, banking entities have entered into swaps with borrower customers that are marked to fair value, but the banking entity itself may not stand ready to buy or sell these swaps through market cycles and on both sides of the market so as to clearly be permitted to rely on the market-making exemption. Absent a new or modified permitted activity exemption, banking entities would likely find it challenging to determine that an existing exemption is clearly available for long-term AFS investments or banking book derivative positions that are captured by the accounting prong but do not qualify for the proposed accounting prong's presumption of compliance (see Section I.B and Section III.D).
- We also note that the accounting prong appears to apply on an instrument-by-instrument basis, and thereby to exacerbate compliance complexity, as the Agencies acknowledge in stating that reliance on the related presumption of compliance can alleviate the burden of "having to assess every individual trade for compliance" with the Volcker Rule.[10]

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[8] For example, the Federal Reserve Board's Form FR Y-9C makes a simple distinction between "trading" and "investment" that appears well-suited for the Volcker Rule trading account definition and does not include AFS securities in the trading account: "When a security or other asset is acquired, a holding company should determine whether it intends to hold the asset for trading or for investment (e.g., for securities, available-for-sale or held-to-maturity)". Federal Reserve Board, Instructions for Preparation of Consolidated Financial Statements for Holding Companies: Reporting Form FR Y-9C (Mar. 2018) at GL-88.

[9] See Proposal at 118-23.

[10] See Proposal at 70; id. at 70 n. 71 ("Provided that a trading desk's absolute P&L does not exceed the $25 million threshold, a banking entity would not have to assess the accounting treatment of each transaction of a trading desk").

- Since many FBOs operating in the United States book a portion of their trading assets in U.S. branches or agencies, the U.S. banking organization subsidiaries of certain FBOs whose U.S. non-branch operations are focused on retail or wholesale lending may not meet the threshold for application of the U.S. market risk capital rule, and thus may not currently be subject to the market risk capital prong of the trading account definition. Accordingly, the expansion of the market risk capital prong for FBOs to encompass all activities subject to regulations implementing the Basel market risk framework either in the United States or in the FBO's home country (applied on a consolidated basis) may, for certain FBOs, capture a materially broader set of positions in the definition of "trading account". This proposed revision could increase burden not only by potentially expanding an FBO's trading account and thus the scope of its exposure to the proprietary trading prohibition, but also by requiring an FBO to revise its systems and controls for identifying and monitoring the trading account for purposes of compliance with the Volcker Rule.

B. Out-of-Scope Presumption Associated with the Proposed Accounting Prong

Summary of Proposed Changes:

- The Proposal would **presume compliance** by a trading desk that is **subject only to the accounting prong** of the trading account definition (i.e., not also subject to the market risk capital or the dealer prong), provided that the **aggregate absolute daily value of net realized and unrealized gains or losses** on the desk's portfolio of financial instruments ("absolute P&L"), calculated daily on a rolling 90-day look-back basis, remains **$25 million or less**.
  - If a banking entity's trading desk **exceeds the $25 million absolute P&L threshold** on any day, the Proposal would require the banking entity to (i) **promptly notify** the appropriate Agency, (ii) demonstrate that the desk **complies with the rule's proprietary trading provisions** (e.g., operates pursuant to one of the rule's exclusions or exemptions from the proprietary trading prohibition, and all associated compliance requirements) and (iii) demonstrate how the desk will **continue to comply on an ongoing basis**.
  - The Agencies emphasize in the preamble to the Proposal that the compliance presumption is **not intended to be a safe harbor**—an Agency may rebut the presumption by providing written notice to a banking entity of the Agency's determination that a trading desk violates the Rule's proprietary trading provisions.

Selected Questions Asked by the Agencies:

- Whether the proposed $25 million absolute P&L threshold for presumed compliance is appropriate.
- Whether there are practical impediments to applying the $25 million absolute P&L threshold at the trading desk level.
- Whether the proposed accounting prong and compliance presumption should apply identically to banking organization affiliates regulated primarily by (i) the SEC or CFTC and (ii) the Federal Reserve Board, OCC or FDIC.

OBSERVATIONS:

- The practical efficacy of the proposed accounting prong's presumption of compliance is unclear, particularly in light of the breadth of positions, including newly captured positions, it encompasses. Commenters may want to address some or all of the following issues:
  - The absolute P&L calculation requires inclusion of "unrealized" gains and losses. For a long-term investment position or a long-term banking book position, current market movements in relation to the original terms of the instrument may create significant daily volatility or price movement. (The calculation does, however, rely on the "net" gain and loss figures across the trading desk's "portfolio",[11] which could mute some of this volatility.) Furthermore, it is not clear how "unrealized" gains or losses are indicative of "activity" on a desk (as stated by the Agencies in the preamble to the Proposal), particularly if the desk holds positions long term in an AFS portfolio. Commenters should explore whether this could be revised to limit the absolute P&L calculation to realized gains and losses that indicate exiting of and entrance into positions.
  - The Agencies state in the Proposal that the $25 million threshold for absolute P&L is designed to be indicative of a desk that has a "de minimis amount of activity", to "correlate with the scale and nature of a trading desk's trading activities" and to evidence whether "the positions of a trading desk have recently significantly contributed to the financial position of the banking entity".[12] Yet a static dollar figure threshold does not take into account relative scale or amount of activity in relation to the desk or the banking entity. Even small movements calculated on an absolute basis, over a large number of positions and over a 90-day period, can accumulate quickly against a static threshold, leading to arbitrary results.
  - A static threshold not tailored relative to the size of the desk or the banking entity could lead banking entities to reconsider desk configuration and desk size.
  - Changes in fair value of the portfolio may be wholly unrelated to the purpose of the investments. For example, fair value may move with the volatility in interest and foreign exchange rates experienced by internationally active institutions as a matter of course.
  - Exceeding the absolute P&L threshold requires "demonstrat[ing] that the trading desk's purchases and sales of financial instruments comply with" the Volcker Rule and "how the banking entity will maintain compliance with [the Volcker Rule] on an ongoing basis".[13] This "springing" compliance requirement significantly undermines any benefit offered by the presumption of compliance because a trading desk, acting prudently in anticipation of an inadvertent or unexpected breach, would be likely to monitor and record how it may prove that its current activity, at any time, is compliant with the Volcker Rule, even though it is

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[11] Presumably "portfolio" means only those instruments booked on the trading desk that are subject to fair value accounting. In addition, the Proposal's text states that the calculation is based on "net gain or net loss on the trading desk's portfolio of financial instruments each business day" (Proposal, § __.3(c)(1)(i)), implying that, although the analysis is intended to be trading-desk-wide, the focus is only on "financial instruments", which is a term specifically defined in the 2013 Final Rule. If so limited, then profits or losses on derivative hedges of, e.g., loans or FX positions (which are not defined as financial instruments) may be captured without offset from the hedged position.

[12] See Proposal at 67-68.

[13] Proposal, §§ __.3(c)(3)(ii) and (iii).

technically relying upon the presumption. (See our comments below in Section III.D concerning potential alternatives to the presumptions in the Proposal.)

- o The breadth of the proposed accounting prong and inflexibility of the absolute P&L threshold is likely to pose challenges to showing how previously out-of-scope long-term AFS investments or banking book derivative positions may satisfy the market-making or risk-mitigating hedging exemptions.

- Potential alternatives that commenters may wish to consider in addressing weaknesses of the proposed compliance presumption could include:
  - o Eliminating the presumption, but significantly reducing the scope of the proposed accounting prong by either incorporating a different scope of accounting definitions or adding further practical exclusions from the trading account.
  - o Expanding the liquidity management exemption to include all derivatives and futures used by asset-liability management functions that are managed by a treasury division in its role as receiver or provider of financing throughout a banking organization.

C. RESERVATION OF AGENCY AUTHORITY TO DESIGNATE A TRADE AS FOR THE TRADING ACCOUNT

SUMMARY OF PROPOSED CHANGES:

- The Proposal would reserve authority for a banking entity's primary regulatory Agency to determine on a case-by-case basis whether the banking entity's purchase or sale of a financial instrument was or was not engaged in as principal for the trading account (subject to an opportunity for the banking entity to submit a response challenging the determination).

SELECTED QUESTIONS ASKED BY THE AGENCIES:

- Whether a determination under the proposed reservation of authority should be made jointly by the Agencies, rather than solely by a banking entity's primary regulatory Agency.
- Whether determinations should be made public, and whether the banking Agencies (Federal Reserve Board, OCC and FDIC) and the market regulatory Agencies (SEC and CFTC) should adopt different notice and response procedures reflecting their different regulatory structures.

OBSERVATIONS:

- See our observations below in Section III.D regarding the interplay between the Proposal's "presumptions of compliance" and its "reservations of authority".
- The Proposal to allow an Agency, through reservation of authority, to determine "that a purchase or sale of one or more financial instruments by a banking entity . . . is not for the trading account"[14] could allow the Agencies to make quicker and more tailored decisions in relation to out-of-scope

[14] Preamble to Proposal at 59-60 (emphasis added).

situations than under the 2013 Final Rule. This flexibility would almost certainly be undermined if the Agencies were to determine that their decisions to exercise this reservation of authority needed to be made jointly. The question of whether the decisions should be made public is more subtle. On one hand, making the decisions public could provide much needed (and previously lacking) guidance to the industry on the scope of the trading account under the Volcker Rule. On the other hand, a public decision-making process is likely to introduce delay, and if banking entities are identified it may create a disincentive to cooperate in the process.

D. UNDERWRITING AND MARKET-MAKING EXEMPTIONS

SUMMARY OF PROPOSED CHANGES:

- The Proposal would establish a **presumption** (available to all banking entities) that a trading desk operating within **internally-set risk limits satisfies the "RENTD" requirement**, which requires that permitted underwriting and market-making activities not exceed the reasonably expected near term demand ("RENTD") of clients, customers and counterparties.
  - Banking entities would be permitted to **base risk limits on internal models and analyses** rather than any mandatory analysis.
  - Internal risk limits would, however, need to be "designed not to exceed the [RENTD] of clients, customers or counterparties, based on the nature and amount of the trading desk's" underwriting/market-making-related activities.
    - Internal risk limits for **underwriting** would need to be set, at a minimum, for (1) the amount, types and risks of the trading desk's underwriting positions, (2) the level of exposures to relevant risk factors arising from the desk's underwriting positions and (3) the period of time a security may be held.
    - Internal risk limits for **market-making** would need to be set, at a minimum, for (1) the amount, types and risks of the trading desk's market-maker positions, (2) the amount, types and risks of the products, instruments and exposures the trading desk may use for risk management purposes, (3) the level of exposures to relevant risk factors arising from the trading desk's financial exposure and (4) the period of time a financial instrument may be held.
- Banking entities would be required **to provide notice** to the appropriate Agency when a trading desk **exceeds or increases its internal risk limits**.
- Internal risk limits would remain subject to Agency oversight, and the Agencies could **rebut the presumption** of compliance based on a determination that a trading desk is engaging in activity not based on RENTD.
- The Proposal would more closely align the market-making and underwriting exemptions' RENTD provisions by (1) eliminating the express requirement in the 2013 Final Rule's market-making exemption that banking entities conduct a **"demonstrable analysis"** of historical customer demand, current inventory of financial instruments and market and other factors regarding the amount, types and risks of or associated with financial instruments in which the trading desk makes a market; and (2) retaining the requirement that an underwriting or market-making desk take "into

account the liquidity, maturity and depth of the market for" financial instruments in order to determine RENTD.

- Banking entities with **limited** (less than $1 billion) and **moderate** ($1 billion to $10 billion) trading assets and liabilities ("TAL") would no longer have to maintain mandatory, exemption-specific compliance programs in order to rely on the underwriting and market-making exemptions.
- Banking entities with **significant** ($10 billion or more) TAL would be required to maintain exemption-specific programs. (See Section III below for further discussion of the role of TAL thresholds in tailoring compliance programs.)

SELECTED QUESTIONS ASKED BY THE AGENCIES:

- What the costs and benefits would be of the proposed elimination of the requirement that banking entities conduct a demonstrable analysis of historical customer demand, current inventory of financial instruments and other analyses mandated under the existing rule in order to comply with the RENTD requirement.
- Whether the proposed changes to the underwriting exemption would work in firm commitment offerings.
- Whether applicable compliance requirements should be further streamlined for banking entities with significant TAL.
- Whether the proposed amendments to the market-making exemption would pose problems for trading desks that make a market in derivatives.
- The timeframe and manner in which banking entities should be required to provide notice to the Agencies of a breach or increase of their internally-set risk limits.
- Whether, in lieu of an affirmative notice requirement, "solely" in the case of a banking entity for which the SEC or CFTC serves as primary federal regulator, the banking entity could be required to make and keep a detailed record of each instance of limit breach or limit increase, to be made available to the SEC or CFTC promptly upon request or during an examination.

OBSERVATIONS:

- The proposal to integrate the concept of risk limits with RENTD compliance appears helpful in leveraging processes that trading desks already undertake (risk management and limit-setting) and appears to shift compliance to a risk-based approach. Using risk limits as a main compliance tool was also suggested by several commenters in the 2012 comment period leading up to the 2013 Final Rule.
- On the other hand, the proposed changes to the rule text may merely codify and streamline the manner in which the Agencies already look at trading desk compliance. To illustrate:
  - The 2013 Final Rule already includes the following provisions that require that limits be established for each trading desk and that these limits incorporate an analysis of RENTD:

        - Section __.4(a)(2)(iii)(B) requires establishment of limits on underwriting desks based on the RENTD of clients, customers or counterparties; and
        - Section __.4(b)(2)(iii)(C) requires establishment of limits on market-making desks "that address the factors prescribed by" earlier sections of the market-making exemption, including that "the amount, types and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis" the RENTD of clients, customers or counterparties.
    - In the preamble to the 2013 Final Rule, the Agencies had indicated that:
        - "The final rule requires that activity by a trading desk under the market-making exemption be evaluated by a banking entity through monitoring and setting limits for the trading desk's market maker inventory and financial exposure".[15]

> "While the near term customer demand requirement directly applies only to the trading desk's market-maker inventory, this does not mean a trading desk may establish other positions, outside its market-maker inventory, that exceed what is needed to manage the risks of the trading desk's market making-related activities and inventory. Instead, a trading desk must have limits on its market-maker inventory, the products, instruments, and exposures the trading desk may use for risk management purposes, and its aggregate financial exposure that are based on the factors set forth in the near term customer demand requirement, as well as other relevant considerations regarding the nature and amount of the trading desk's market making-related activities".[16]

- Since the use of internal risk limits incorporating RENTD already figures significantly into the existing market-making and underwriting exemptions, among the most important proposed modifications to these exemptions in the Proposal appears to be the requirement that banking entities notify the appropriate Agency of limit breaches and increases. Expanded Agency notification requirements are likely to increase compliance burdens related to these exemptions.
    - The 2013 Final Rule permits the compliance program for a trading desk to contain "authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), [and] demonstrable analysis of the basis for any temporary or permanent increase to a trading desk's limit(s)".[17] Furthermore, for market-making desks, "[t]o the extent that any limit . . . is exceeded, the trading desk [must] take[] action to bring the trading desk into compliance with the limits as promptly as possible

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15 Preamble to 2013 Final Rule, 79 Fed. Reg. at 5592.

16 Preamble to 2013 Final Rule, 79 Fed. Reg. at 5605.

17 2013 Final Rule, § __.4(a)(2)(iii)(D); see also 2013 Final Rule, § __.4(b)(2)(iii)(E).

after the limit is exceeded".[18] In addition, trading desks are required to maintain records in a manner facilitating review of a desk's compliance by the Agencies.[19]

- o However, the Proposal would require that, in order to use internally-set risk limits (which must be designed through the lens of RENTD, similar to the current Volcker Rule requirements)[20] to presume compliance with the RENTD requirement, "a banking entity shall promptly report to the [Agency] (A) to the extent that any limit is exceeded and (B) any temporary or permanent increase to any limit(s)".[21]

- In this respect, the Proposal appears more onerous than the 2013 Final Rule's requirements for internal escalation, approval, remediation and recordkeeping procedures. In addition, the proposed notification requirement could reduce the operating efficiency of trading desks, and require potentially large numbers of breach/limit increase notification filings.
  - o SEC staff has indicated that they expect to see risk limit breaches occur in a well-functioning and controlled trading desk operation from time to time.
  - o If risk limit breaches are expected, then a presumption of compliance that lasts only so long as limits are not breached, combined with the formal requirement to notify Agency staff of any breach, raises the question whether the presumption will be meaningful in practice or whether the practical result will simply be an increase in compliance costs and related regulatory obligations.
- The Proposal requests comment on whether the Proposal should be modified to allow what the 2013 Final Rule currently permits (i.e., internal procedures for recordkeeping around limit breaches, coupled with production of such records during exams by an Agency), but only in the context of banking entities primarily regulated by the SEC or CFTC.[22] No indication is provided that the banking Agencies would be willing to monitor compliance in the same manner. In addition to increased burden and formal reporting requirements on certain banking entities, such a divergence in compliance requirements would appear inconsistent with the Agencies' suggestion in the preamble to the Proposal that "coordinat[ion of the Agencies] . . . is important to . . . foster a level playing field for affected market participants . . . and provides for more efficient regulation".[23]
- The permission for banking entities with limited and moderate TAL to no longer maintain mandatory, exemption-specific compliance programs in order to rely on the underwriting and market-making

[18] 2013 Final Rule, § __.4(b)(2)(iv).

[19] See Preamble to 2013 Final Rule, 79 Fed. Reg. at 5573 (an underwriting desk "must maintain documentation and records with respect to these elements, consistent with the requirement of § __.20(b)(6)"); 2013 Final Rule, § __.20(b)(6).

[20] For requirements under the Proposal that risk limits must be designed not to allow the desk to exceed RENTD, see Proposal, §§ __.4(a)(8)(i)(B), __.4(a)(8)(ii), __.4(a)(8)(iv), __.4(b)(6)(i)(B), __.4(b)(6)(ii), __.4(b)(6)(iv).

[21] Proposal, §§ __.4(a)(8)(iii), __.4(b)(6)(iii).

[22] See Preamble to Proposal at 98 (Question 76, "Should the Agencies implement an alternative reporting methodology . . . that would apply solely in the case of a banking entity's obligation to report to a market regulator? For example, instead of an affirmative notice requirement, should such banking entities be required to make and keep a detailed record of each instance as part of its books and records, and to provide such records to SEC or CFTC staff promptly upon request or during an examination?"); accord Preamble to Proposal at 114 (Question 95).

[23] Preamble to Proposal at 16.

exemptions appears fairly limited in effect. For a trading desk to benefit from the presumption of compliance with the RENTD requirements by establishing internal risk limits, the banking entity is required to establish a compliance policy (reviewable by the appropriate Agencies) that ensures that risk limits are (i) set in relation to the nature and amount of the desk's underwriting/market-making-related activities and (ii) established for the required risk factors noted in the proposed regulation.

E. Risk-Mitigating Hedging Exemption

Summary of Proposed Changes:

- The Proposal would eliminate two requirements of the exemption as implemented in the 2013 Final Rule:
  - The requirement to conduct a **correlation analysis**; and
  - The requirement that a banking entity show that a hedge "**demonstrably"** reduces or otherwise significantly mitigates an identifiable risk.
- Banking entities with **limited and moderate TAL**:
  - Would no longer have to maintain mandatory, exemption-specific **compliance programs** in order to rely on the risk-mitigating hedging exemption, but banking entities with **significant TAL** would be required to maintain exemption-specific programs. (See Section III below for further discussion of the use of TAL in tailoring compliance programs.)
  - Would remain subject to the requirements that the hedge be "**designed**" at inception to reduce or otherwise significantly mitigate an identifiable risk and, as appropriate, to ongoing recalibration.
  - Would no longer be subject to **enhanced documentation requirements** for certain hedging activities undertaken across desks, for more than one desk or outside the scope of a desk's hedging policy.
    - However, banking entities with **significant TAL** would continue to be subject to these enhanced documentation requirements, unless the hedging activities are undertaken pursuant to certain pre-approved lists of commonly used financial instruments and hedging limits.

Selected Questions Asked by the Agencies:

- Whether to incorporate accounting principles into the exemption, and in particular whether hedging activity receiving special accounting treatment under FASB ASC 815 (Derivatives and Hedging) should be exempted.
- Whether additional clarity is needed regarding the determination of which financial instruments are "commonly used by the trading desk" in connection with the proposed relief from enhanced documentation requirements available for banking entities with significant TAL.
- With regard to the intersection between the risk-mitigating hedging exemption and market-making hedging, and more broadly in relation to interaction between trading desks, whether a trading desk

should be permitted to undertake risk-mitigating hedging transactions for an affiliated trading desk, focusing particularly on the following scenarios:

- Whether a market-making trading desk and an affiliated trading desk that may or may not engage in market-making activities should be permitted to treat each other as a client, customer or counterparty for purposes of establishing risk limits or RENTD levels under the market-making exemption;
- Whether affiliated trading desks should be permitted to treat swaps executed between the desks as permitted market-making activities without treating each other as clients, customers or counterparties, where the swaps are entered into within the limits established for each desk; and
- Whether a non-market-making desk may undertake a hedging transaction for an affiliated market-making desk, where the resulting position is attributed to the affiliated market-making desk's financial exposure and is undertaken in compliance with that desk's risk management policies and procedures.

OBSERVATIONS:

- The Proposal's suggestion that the Agencies could allow hedging transactions to occur as enterprise-wide risk management transactions could reduce uncertainty about interdesk interactions (such as treating an affiliated desk as a client, customer or counterparty, or looking through an affiliated desk to its ultimate third-party client, customer or counterparty). This approach appears consistent with the basic focus of the Volcker Rule on purchases and sales by a banking organization from and to unaffiliated third parties (i.e., the focus on when risk enters or leaves the organization), rather than concerns about the movement of risk within the organization.
- Commenters should consider using the questions about interdesk scenarios as an opportunity to clarify the applicability of, and to reduce the burdens of, the Volcker Rule to "flat" desks. During implementation of the 2013 Final Rule, many banking entities were informed by the Agencies that desks that face customers in customer facilitation transactions—(e.g., private bank or wealth management units that are not themselves risk managing desks, and consequently back-to-back the transactions perfectly to a market-making desk, for example in the corporate/investment bank units)—should nevertheless have compliance and metrics-reporting procedures in place. This primarily occurred in connection with desks that backed-to-back derivative transactions, as often securities transactions could make use of the riskless principal exclusion even between affiliated desks. The Agencies should clarify either that:
  - The Volcker Rule need not apply to the "flat" desks; and/or
  - The riskless principal exclusion can apply to swaps, futures and other derivatives.
- It is unclear why the Agencies raised the third scenario (asking whether a desk may undertake a hedging transaction for an affiliated market-making desk, where the resulting position is attributed to the market-making desk's financial exposure and is undertaken in compliance with that desk's risk management policies and procedures). The preamble of the 2013 Final Rule had already stated that such a transaction was permissible within the hedged desk's market-making authority, and the preamble to the 2013 Final Rule had stated (as does the Proposal's preamble) that transactions

falling outside these parameters should use the risk-mitigating hedging exemption.[24] The Agencies' intent may have been to seek confirmation of the viability of this alternative if the others cited above are not feasible.

F. "Trading Outside the United States" ("TOTUS") Exemption – Permitted Offshore Trading Activities of FBOs

Summary of Proposed Changes:

- The Proposal would **eliminate several conditions** to the TOTUS exemption, which is available to FBOs, including the conditions:
  - Restricting TOTUS transactions conducted **with or through a U.S. entity**;
  - Prohibiting the **financing** of a TOTUS transaction by an FBO's U.S. branch or affiliate; and
  - Requiring that any FBO personnel who **"arrange, negotiate or execute"** a TOTUS transaction be located outside the United States (the "ANE Restriction"). However, the Proposal would retain the condition that any banking entity personnel inside the United States not be decision-making or executing personnel for TOTUS transactions.

Selected Questions Asked by the Agencies:

- Whether the proposed modifications would result in competitive disadvantages for U.S. banking entities, in particular in relation to the elimination of the ANE restriction and restrictions on trading with or through a U.S. entity.
- Whether other conditions should be adopted to address the possibility that risks could flow to the U.S. financial system through financing of TOTUS transactions by U.S. branches or affiliates.
- Whether the proposed modification permitting trading with or through a U.S. entity could have an effect on the safety and soundness of U.S. institutions, the financial stability of the United States or the liquidity of U.S. financial markets.

Observations:

- The proposed changes to the TOTUS exemption's requirements appear designed to better align the reach of the Volcker Rule with the extraterritorial limits that Congress and federal banking regulators have historically observed, for example when applying the activity and other restrictions of the Bank Holding Company Act of 1956 (the "BHC Act"). The Federal Reserve Board had traditionally taken a territorial approach to application of the BHC Act, generally imposing restrictions on FBOs with respect to activities conducted and booked in the United States through branches, agencies and subsidiaries.[25]

[24] See 2013 Final Rule, 79 Fed. Reg. at 5594 and 5617.

[25] See BHC Act § 4(c)(9), 12 U.S.C. § 1843(c)(9) (exempting acquisition of, or activities conducted by, "any company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States"); BHC Act § 4(c)(13), 12 U.S.C. § 1843(c)(13) (exempting acquisition of, or activities conducted by, "any

- The retention of the TOTUS requirement that "the banking entity engaging as principal in the purchase or sale (including relevant personnel) is not located in the United States or organized under the laws of the United States or of any State"[26] should be read together with the preamble explanation that the applicable proposed TOTUS modifications were designed to "restrict only the relevant personnel engaged in the banking entity's decision in the purchase or sale [of a financial instrument pursuant to the TOTUS exemption]," and that "some involvement by U.S. personnel (e.g., arranging or negotiating) would be consistent with this exemption".[27] While there may be some interpretive questions regarding the "relevant personnel" clause in this condition of the TOTUS exemption, its core purpose as clarified in the Proposal appears straightforward: "[t]he banking entity (including relevant personnel) that makes the decision to purchase or sell as principal is not located in the United States or organized under the laws of the Unites States or of any State".
- Global booking models (i.e., where management and order-taking for a trading book are turned over to different regions during the course of a 24-hour day) may continue to present questions about the scope of permissible activities under TOTUS, even with the changes proposed, given that U.S. personnel may be involved in execution and may have a certain amount of discretion for trades during the course of the U.S. business day.
  - In this respect, an approach that requires the "ultimate mind and management" for the trading activity to be located outside the United States would appear to provide more flexibility (and would be consistent with long-standing banking law doctrines developed under the BHC Act).
  - It is possible that reasonable approaches could be developed consistent with the "ultimate mind and management" principle, within the proposed revisions to the TOTUS framework.

G. Liquidity Management Activities Exclusion

Summary of Proposed Changes:

- The liquidity management exclusion would be expanded beyond securities to permit banking entities to use **FX forwards**, **swaps** and **physically-settled cross-currency swaps** to manage liquidity pursuant to a documented liquidity management plan.

Selected Questions Asked by the Agencies:

- Whether any other financial instruments should be covered by the liquidity management exclusion.

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company which does no business in the United States except as an incident to its international or foreign business"). See also 12 C.F.R. §§ 211.23(f)(1) and (2) (permitting qualifying FBOs to "[e]ngage in activities of any kind outside the United States" and to "[e]ngage directly in activities in the United States that are incidental to its activities outside the United States").

26 Proposal, § __.6(e)(3)(i) (emphasis added).

27 Proposal at 141.

OBSERVATIONS:

- The Agencies' decision to omit derivatives from the liquidity management exclusion in the 2013 Final Rule was widely criticized by the industry, and has been a continuous topic of advocacy. Derivatives are an integral part of a traditional treasury function.
- If the accounting prong and its related presumption of compliance were adopted as proposed, it would be helpful (and perhaps necessary) for the liquidity management exclusion to be broadened, as banking entities are likely to find it challenging to defend holding long-term AFS security portfolios scoped into the trading account by the accounting prong in reliance on the market-making exemption (likely the only available exemption).
- To this end, the liquidity management exclusion could be expanded to include (i) all financial instruments and (ii) desks or business units that engage in treasury, financing and asset-liability management (and not solely liquidity) functions pursuant to appropriate policies and procedures that define the purpose of the business unit's purchases and sales and that set appropriate risk limits.

H. CORRECTION OF TRADE ERRORS EXCLUSION

SUMMARY OF PROPOSED CHANGES:

- The Proposal would exclude **transactions made in error**, as well as subsequent transactions to correct the error.
  - A financial instrument purchased in error would need to be transferred to a separately managed error account for subsequent disposition.
  - The availability of the proposed exclusion would depend on facts and circumstances. Indications that a trade was not genuinely made in error could make the trade ineligible for the exclusion—e.g., where a banking entity fails to make reasonable efforts to prevent errors from occurring, as indicated by the magnitude or frequency of errors, or fails to identify and correct trading errors in a timely and appropriate manner.

SELECTED QUESTIONS ASKED BY THE AGENCIES:

- Whether this proposed exclusion conflicts with any requirements of self-regulatory organizations ("SROs") for correcting trading errors and, if so, whether substituted compliance with SRO rules would be appropriate.

OBSERVATIONS:

- Identifying a permissible way to correct trade errors under the Volcker Rule has been an issue of concern for the industry since shortly after the 2013 Final Rule was adopted. Trade errors are inevitable, so banking entities have been left to devise practical and risk-based approaches in the absence of formal guidance from the Agencies.

- Including a more formal exclusion in the Volcker Rule for trade errors would alleviate uncertainty in this area and is likely to be supported by industry commenters.

I. Treatment of Loan-Related Swaps

Selected Questions Asked by the Agencies:

- The Agencies invited comment on three alternative means of permitting "loan-related swaps" under the proprietary trading restrictions:
  - Permitting a banking entity to rely on the **market-making exemption** where the banking entity stands ready to enter into a loan-related swap whenever a customer makes an appropriate request, even if infrequently and even if loan-related swaps are primarily entered into in one direction;
  - Excluding loan-related swaps from the **definition of "proprietary trading"** where the banking entity purchases (or sells) a swap with a customer and contemporaneously sells (or purchases) an offsetting derivative in connection with a loan or open credit facility between the banking entity and the customer, if the rate, asset, liability or other notional item underlying the swap with the customer is, or is directly related to, a financial term of the loan or open credit facility with the customer; or
  - Adopting a **new permitted activity exemption** for loan-related swaps pursuant to the Agencies' exemptive authority under Section 13(d)(1)(J) of the Volcker Rule.
- The Agencies also invited comment on:
  - How loan-related swaps should be defined;
  - What conditions should be placed on the types, volume or other characteristics of permitted loan-related swaps;
  - Whether use of loan-related swaps under an exclusion or as a permitted trading activity should be limited to certain banking entities; and
  - Whether any other types of swaps should be treated in the same manner as loan-related swaps.

Observations:

- Accommodating banking entities' ability to enter into loan-related swaps would appear to most observers to be a "no-brainer". Loan-related swaps are a traditional and important banking activity directly related to prudent extension of credit to customers. Indeed, for many smaller banks, loan-related swaps are the only activity they conduct that potentially implicates the Volcker Rule.
- This request for comment, and the industry questions that led to it, highlight how narrowly the 2013 Final Rule had interpreted the statutory permission to engage in purchases and sales "on behalf of customers".[28] Loan-related swaps are clearly customer facilitation transactions and not

[28] 12 U.S.C. § 1851(d)(1)(D).

likely to be or to promote proprietary trading. Nevertheless, the request for comment (rather than inclusion of language in the Proposal or previously issuing a FAQ) evidences the Agencies' continued debate over the use of the authority and power granted by the statute to permit customer transactions of all types. One of the most significant complexities and ambiguities experienced in complying with the 2013 Final Rule is the need to fit trading account transactions into one of only three permitted activities (market-making, underwriting or risk-mitigating hedging), even if a transaction is clearly customer-driven.

- The loan-related swap "problem" is in part a function of the 2013 Final Rule's lack of tailoring of the market-making exemption for derivative transactions. The market-making definition in the 2013 Final Rule lacked the nuances that some of the Agencies had developed over time in the context of swap market-making, including for purposes of Title VII of the Dodd-Frank Act, in contrast to securities dealing.[29]
- It is not clear that a loan-related swap should be defined to include a requirement that the swap is contemporaneously offset with a third party. If a bank can offer a fixed rate loan to a customer, it should be permitted, pursuant to basic bank powers, to offer a floating rate loan coupled with an interest rate swap without needing to offset the swap with the market.

J. DEFINITION OF "TRADING DESK"

SELECTED QUESTIONS ASKED BY THE AGENCIES:

- The Agencies invited comment on the following alternative multi-factor trading desk definition:
  - 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:
    - Structured by the banking entity to establish efficient trading for a market sector;
    - Organized to ensure appropriate settling, monitoring and management review of the desk's trading and hedging limits, current and potential future loss exposures, strategies and compensation initiatives; and
    - Characterized by a clearly-defined unit of personnel that typically:
      - engages in coordinated trading activity with a unified approach to its key elements;
      - operates subject to a common and calibrated set of risk metrics, risk levels and joint trading limits;
      - submits compliance reports and other information as a unit for monitoring by management; and
      - books its trades together.

[29] Compare CFTC and SEC, "Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Participant' and 'Eligible Contract Participant'", Final Rule, 77 Fed. Reg. 30596, 30609-10 (May 23, 2012) (indicating that the "relevant indicator" of swaps market-making is the "willingness" to enter into swaps at "request or demand" of a counterparty, whether or not it is on one or both sides of the market), with SEC, "Amendments to Regulation SHO", Final Rule, 73 Fed. Reg. 61690, 61699 (Oct, 17, 2008) (securities dealers exhibit a "pattern of trading . . . on both sides" of the market "on a regular or continuous basis").

- Whether this (or another) alternative multi-factor definition would reduce compliance costs by aligning the definition of "trading desk" under the Volcker Rule with the meaning of the term in other contexts (e.g., for purposes of banking entities' internal risk management and reporting and calculation of regulatory capital requirements).

OBSERVATIONS:

- From 2012 through 2016, the Basel Committee on Banking Supervision (the "Basel Committee") conducted its "Fundamental Review of the Trading Book" in order to implement post-crisis modifications to the market risk capital framework. In January 2016, the Basel Committee released a final set of standards for market risk[30] that bases model approval and overall compliance requirements on the concept of a "trading desk". The U.S. banking Agencies' current market risk capital rules do not apply the concept of a trading desk, and these Agencies have not yet implemented the Basel Committee 2016 Market Risk Standards. However, at industry conferences in 2018, Federal Reserve Board staff helpfully indicated a concern about the inefficiencies of having two separate compliance regimes with differing approaches to the trading desk concept.
- The approach of the 2013 Final Rule ("the smallest discrete 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")[31] would appear to be too narrow a definition to allay concerns of inconsistency with the Basel Committee 2016 Market Risk Standards. Those Standards have a broader, principles-based approach to the definition, focusing on (i) "an unambiguously defined group of traders or trading accounts", (ii) with a "well-defined business strategy", (iii) with a "clear risk management structure" and (iv) that is proposed by the bank but approved by supervisors. The Market Risk Standards contain certain more granular requirements regarding personnel, primary activities, limit setting and risk reporting, etc., but do not require that the trading desk be the "smallest discrete" trading unit. For the sake of efficiency among these (and other) regulatory regimes, commenters likely will want to encourage the modifications identified by the Agencies, as they do not appear inconsistent with the Market Risk Standards.

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[30] Basel Committee, Minimum Requirements for Market Risk (Jan. 2016) ("Basel Committee 2016 Market Risk Standards"). See also Basel Committee, Consultative Document: Revisions to the Minimum Capital Requirements for Market Risk (Mar. 2018, with comments due June 20, 2018).

[31] 2013 Final Rule, § __.3(e)(13).

II. COVERED FUNDS – KEY PROPOSED CHANGES, QUESTIONS AND OBSERVATIONS

A. DEFINITION OF "COVERED FUND" – BASE DEFINITION

SUMMARY OF PROPOSED CHANGES:

- The Agencies **do not propose any changes** to the covered fund definition in the Proposal, but solicit comment on several potential approaches to revising its scope in order to avoid "unintended results" resulting from a definition that may be "inappropriately imprecise".
- The Agencies solicit comment on whether to modify the **"base definition"** that currently captures all vehicles that would be an "investment company" under the Investment Company Act of 1940 (the "1940 Act") but for the exemptions available under Sections 3(c)(1) or 3(c)(7) of that act; similar private commodity pools; and (as to U.S. banking entities) similar foreign funds.
- However, the Agencies focus most of their questions on whether **exclusions from the base definition** should be added or modified, including exclusions for entities that do not exhibit the characteristics of a private equity or hedge fund, foreign public funds, family wealth management vehicles, joint ventures and municipal securities tender option bond vehicles.

SELECTED QUESTIONS ASKED BY THE AGENCIES:

- Whether the base definition of "covered fund" in the 2013 Final Rule should be modified, or alternatively whether exclusions from that definition should be added or modified.
- What costs or burdens might result from changing the base definition of "covered fund", and whether those could be mitigated if the Agencies modified or added exclusions rather than changing the base definition.
- Whether to adopt separate definitions of "hedge fund" and "private equity fund" rather than relying on a unified "covered fund" definition.
- What kinds of compliance and other costs banking entities have incurred in analyzing whether particular issuers are covered funds and in implementing compliance programs for covered fund activities.
- Whether concerns about the overbreadth of the covered funds definition would be addressed or mitigated by changes the Agencies are proposing to other covered funds provisions or on which the Agencies are seeking comment.

OBSERVATIONS:

- The industry has long expressed concern about the overbreadth of the definition of "covered fund",[32] which the Agencies sought to narrow in the 2013 Final Rule in large part by excluding

[32] As implemented by the Agencies in the 2013 Final Rule: (i) an issuer that would be an "investment company," as defined in the 1940 Act, but for the exemptions from that definition in Sections 3(c)(1) or 3(c)(7) of the 1940 Act; (ii) certain similar commodity pools; and (iii) for U.S. organized or located banking entities and their subsidiaries, similar foreign funds that the banking entity or its affiliate "sponsors" or in which it holds an ownership interest.

more than a dozen types of entities determined not to resemble traditional private equity and hedge funds.

- Both the Treasury Report and many market participants have recommended that the Agencies adopt a characteristics-based definition of "covered fund".[33] Although the Agencies include one sentence asking whether they should adopt a characteristics-based definition, this question is subsumed in the section of the preamble discussing whether the Agencies should adopt an exclusion based on characteristics. The Agencies have previously expressed concerns about the limits on their flexibility to revise the base definition given its appearance in the statute. Adopting a new base definition would require reading the "or such similar funds" language in the statutory definition as empowering the Agencies to adopt an alternative definition, as opposed to empowering them to sweep additional funds into the covered funds definition. It seems likely they will continue to prefer the approach of using exclusions from the statutory base definition to "tailor" the definition to be consistent with congressional intent with respect to the types of vehicles covered by the Rule.
- Fashioning a characteristics-based limitation as an exclusion rather than a revision to the base definition should achieve the same result, and may even be more workable in practice.
- The Agencies' pointed questions about the potential costs and burdens of revising the base definition highlight a concern shared by some industry participants about whether a different base definition (or material changes to the exclusions) could actually increase the difficulty of identifying covered funds and require them to incur additional costs. Industry participants have already invested significant resources in identifying covered funds and in compliance policies and procedures. The Agencies cite back to their statements in the preamble to the 2013 Final Rule that a characteristics-based definition could create additional compliance costs.
- Advocating for changes that remove existing limits on exclusions, rather than proposing new standards that could be adopted in ways that create unintended consequences, may help mitigate the risk of increased uncertainty or compliance costs where such an approach is possible.
- The Agencies also asked whether they should separately define "hedge fund" and "private equity fund", rather than retaining a unified definition of "covered fund". While such a change may not seem important or create a substantive difference in the definition, it could be helpful on the margins in focusing attention on the intended scope of the statute, both in the current rulemaking and in resolving interpretive questions going forward. Calling funds subject to the Rule's limitations "covered funds" may make it easier for the scope of the definition to become disassociated from the original congressional intent and legislative language, which was focused on hedge funds and private equity funds. For example, an argument that certain investments vehicles (e.g., a collateralized debt obligation ("CDO"), or a joint venture ("JV") structure) have been inappropriately swept into the definition may appear stronger on its face when the question is whether those are "hedge funds" or "private equity funds" as opposed to whether they fall within the term "covered fund", which lacks an independent meaning.
- The changes to the covered funds market-making and underwriting exemptions, and to the risk-mitigating hedging exemption, do effectively mitigate many of the practical difficulties associated with the overbroad covered funds definition, especially in the context of secondary market trading (see Sections II.J and II.K below). In particular, by removing the requirements to deduct from capital and count towards the aggregate 3% limit interests in third-party covered

[33] Treasury Report, at 77.

funds, the Agencies potentially eliminate the need to determine whether interests acquired under those exemptions are covered funds or not, and remove what was previously a significant practical obstacle to utilizing those exemptions. However, since those requirements were not removed with respect to a banking organization's own sponsored or advised funds, the overbreadth of the covered funds definition remains problematic even in the context of those exemptions. The changes to those exemptions also do not address banking entity investments not made in a market-making capacity, or the impact on traditional asset management or securitization businesses.

B. Characteristics-Based Exclusion

Summary of Proposed Changes:

- The Agencies do not propose a new exclusion for entities that lack characteristics commonly associated with a hedge fund or private equity fund, but they solicit comment on adopting such an exclusion.

Selected Questions Asked by the Agencies:

- What particular traits or characteristics are associated with a private equity or hedge fund, and whether the exclusion should carve out entities that exhibit none (or only some) of those characteristics.
- Whether the Agencies should exclude from the base definition an entity that does not meet the (characteristics-based) definitions of "hedge fund" and "private equity fund" set out in the SEC's Form PF, and whether any modifications to those Form PF definitions should be made for purposes of the covered fund definition.
  - Form PF defines a "hedge fund" as a "private fund (other than a securitized asset fund): (a) with respect to which one or more investment advisers (or related persons of investment advisers) may be paid a performance fee or allocation calculated by taking into account unrealized gains (other than a fee or allocation the calculation of which may take into account unrealized gains solely for the purpose of reducing such fee or allocation to reflect net unrealized losses); (b) that may borrow an amount in excess of one-half of its net asset value (including any committed capital) or may have gross notional exposure in excess of twice its net asset value (including any committed capital); or (c) that may sell securities or other assets short or enter into similar transactions (other than for the purpose of hedging currency exposure or managing duration)".[34] Certain commodity pools are also categorized as hedge funds for Form PF purposes.
  - Form PF defines a "private equity fund" in less prescriptive terms as "[a]ny private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund and does not provide investors with redemption rights in the ordinary course".[35]

[34] Preamble to Proposal at 177.

[35] Preamble to Proposal at 178.

- The Form PF definition of "private equity funds" would not include venture capital funds, and the Agencies solicit comment on whether they should specify that venture capital funds would be covered funds if they adopt an exclusion based on the Form PF definitions.

- Whether the Agencies should design their own set of private equity fund characteristics instead of using the Form PF definition of "private equity fund", which does not itself specify characteristics. The Agencies suggest a potential list, noting that "private equity funds commonly (i) have restricted or limited investor redemption rights; (ii) invest in public and nonpublic companies through privately negotiated transactions resulting in private ownership of the business; (iii) acquire the unregistered equity or equity-like securities of such companies that are illiquid as there is no public market and third-party valuations are not readily available; (iv) require holding investments long-term; (v) have a limited duration of ten years or less; and (vi) realize returns on investments and distribute the proceeds to investors before the anticipated expiration of the fund's duration".[36]

- Whether the definition should exclude a fund that (i) is not engaged in selling financial instruments in the near term, or otherwise with the intent to resell in order to profit from short-term price movements, and (ii) does not invest, or principally invest, in illiquid assets, such as portfolio companies, real estate investments and venture capital investments.

OBSERVATIONS:

- Continuing prior industry efforts to advocate for a characteristics-based definition (or limit on the base definition), some industry participants had advocated in recent comments for excluding funds that are not principally engaged in short-term proprietary trading of financial instruments.[37] The Treasury Report also supported a characteristics-based approach. The legislative history of the Volcker Rule suggests that the primary policy rationale for the covered funds prohibition was to prevent evasion of the proprietary trading prohibition,[38] and thus limiting the definition to capture

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[36] Preamble to Proposal at 178-79.

[37] See, e.g., Securities Industry and Financial Markets Association, Letter to OCC (Sept. 21, 2017), Annex A at 22 ("The definition of 'covered fund' should be revised so that it is limited to an entity that would be an investment company, as defined in the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act, that is principally engaged in short-term proprietary trading of financial instruments, defined as trading conducted by the entity for the primary purpose of generating profits from short-term price movements."); Institute of International Bankers, Letter to OCC (Sept. 21, 2017), at 29-31 ("Replace the current definition of covered fund with an activities-based definition focused on private funds that engage primarily in short-term proprietary trading in order to implement the original purpose of the covered fund prohibition.") (emphasis added). See also The Clearing House Association, Submission to U.S. Treasury Department (May 2, 2017), at 35; Institute of International Bankers, U.S. Supervision and Regulation of International Banks: Recommendations for the Report of the Treasury Secretary (Apr. 28, 2017), at 57.

[38] See 156 Cong. Rec. S5895 (daily ed. July 15, 2010) (statement by Sen. Merkley) ("The new Bank Holding Company Act section 13 also restricts investing in or sponsoring hedge funds and private equity funds. Clearly, if a financial firm were able to structure its proprietary positions simply as an investment in a hedge fund or private equity fund, the prohibition on proprietary trading would be easily avoided, and the risks to the firm and its subsidiaries and affiliates would continue".) (emphasis added). See also FSOC, Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds (Jan. 18, 2011), at 6 (describing the first purpose of the covered funds restrictions as "[e]nsuring that banking entities do not invest in or sponsor [covered] funds

only funds engaged in proprietary trading appears consistent with legislative intent. However, the preamble to the Proposal suggests that the Agencies are reluctant to adopt an approach that would exclude private equity funds; the Agencies note that the statute contemplates funds that make longer-term investments (e.g., by reference to an extended conformance period for "illiquid funds") and specifically refers to "private equity funds," although the statute does not define the term. It is notable that the Agencies do not ask for comment on an approach that would exclude all funds that are not engaged in proprietary trading, as advocated by many in the industry in light of the origin of the Volcker Rule's covered fund restrictions as a means of preventing evasion of the proprietary trading prohibition.

- The Agencies' question regarding whether the existing covered fund definition captures funds that "do not engage in the investment activities contemplated by section 13" may suggest a further limiting principle, whereby a fund might be excluded from covered fund status where it engages only in activities in which a banking entity would be permitted to engage directly. There is arguably no clear policy rationale for prohibiting investment in a fund that holds interests in portfolio companies that a banking organization could hold directly.
- However, the Agencies' question about excluding funds that neither engage in proprietary trading nor invest (or principally invest) in illiquid assets may suggest that the Agencies view that as the baseline of what is required under the statute. The scope of "illiquid assets" in the Agencies' question tracks the definition of that term as used in respect of "illiquid funds" in the statute. Commenters will want to consider how many vehicles could benefit from such a carveout that are not covered by other existing exclusions or potential new or modified exclusions on which the Agencies have solicited comment.
- Crafting a characteristics-based exclusion that is both consistent with the Agencies' apparent reading of the statute and still effectively excludes vehicles inappropriately swept in by the current definition would appear likely to be well-received by the Agencies.
- Industry commenters have long requested a carveout for venture capital funds. However, in posing a question in the Proposal about whether to specify that venture capital funds would be "covered funds" if the Form PF definitions of a "private equity fund" and a "hedge fund" were used as a baseline for an exclusion, the Agencies make note of their analysis and conclusion in the preamble to the 2013 Final Rule that there is evidence of congressional intent to include venture capital funds.[39] This suggests that advocacy efforts to exclude venture capital funds will need to specifically address that legislative history.
- Commenters may find the Form PF definition of "hedge fund" to be a practical foundation for a characteristics-based exclusion from the covered fund definition. The definition is now familiar to banking entities accustomed to Form PF reporting requirements, and a general exclusion for vehicles that lack the three characteristics identified in the definition would likely be a helpful supplement to the rule's more specific exclusions.
- As several of the Agencies' questions imply, however, the Form PF definition would likely need to be adapted for use in the Volcker Rule context. For example, the definition was not designed to

as a way to circumvent the Volcker Rule's restrictions on proprietary trading," and also noting that the covered funds restrictions are "guided by the same purposes as the prohibition on proprietary trading . . . .").

[39] Preamble to Proposal at 179.

capture the subset of commodity pools that the Agencies identified in the 2013 Preamble as "similar to funds that rely on section 3(c)(1) and 3(c)(7) [of the 1940 Act] in that . . . [they] may be owned only by investors who meet certain heightened qualification standards".[40] Rather, it captures issuers that (i) are both commodity pools and issuers that would be investment companies but for 3(c)(1) or 3(c)(7) ("private funds"), as well as (ii) any other commodity pool that a commodity pool operator or commodity trading advisor may choose to report on Form PF in lieu of making a separate filing with the CFTC. As the Agencies are unlikely to adopt an exclusion that materially reduces the scope of "covered commodity pools", commenters should consider reasonable modifications or additions to the Form PF definition that align more closely with the Agencies' conception of "similar" commodity pools. Except in the case of the second category of "commodity pools" described above, the Form PF "hedge fund" definition in its current form is limited to "private funds". Accordingly, the Form PF definition does not currently capture non-U.S. investment companies that offer their securities solely offshore and so do not need to rely on Sections 3(c)(1), 3(c)(7) or any other 1940 Act exemption in order to comply with the requirements of the Act (sometimes called "7(d)" funds). The third prong of the 2013 Final Rule's definition of covered fund, however, treats a 7(d) fund as a covered fund where (i) a U.S. banking entity sponsors or holds an ownership interest in the fund and (ii) the fund invests in securities for resale or otherwise trades in securities. Because the Agencies are unlikely to adopt an exclusion that materially reduces the scope of this third prong, the Form PF definition would need to be modified to specifically exclude 7(d) funds that lack that definition's identified characteristics.

- As the Agencies note in the Proposal, Form PF's definition of "private equity fund" is limited to 3(c)(1)/3(c)(7) funds that are not "hedge funds", "liquidity funds", "real estate funds", "securitized asset funds" or "venture capital funds", as defined in the form. Adapting this definition for use as a covered fund exclusion palatable to the Agencies would therefore likely be difficult and of limited use in excluding funds captured by the overbreadth of the 2013 Final Rule's reference to 3(c)(1)/3(c)(7). The Agencies offer an alternative characteristics-based definition of "private equity fund" for comment that resembles past industry proposals.[41] Commenters should consider whether the characteristics the Agencies have identified would serve as an appropriate basis for exclusion, including what reasonable modifications would be necessary (e.g., the characteristic limiting the duration of a private equity fund to a maximum of ten years would not accommodate typical infrastructure funds and many real estate funds).

C. Foreign Public Funds ("FPFs") – Exclusions From Definition of "Covered Fund"

Summary of Proposed Changes:

- Although the Agencies do not propose affirmative changes to the existing FPF exclusion, the Proposal solicits comment on a number of the exclusion's conditions that the industry has identified as impractical, unnecessary or posing particularly burdensome compliance obligations.

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40 Preamble to 2013 Final Rule, 79 Fed. Reg. at 5675.

41 See, e.g., Securities Industry and Financial Markets Association, Comment Letter to Agencies (Feb. 13, 2012), Annex B at B-2.

SELECTED QUESTIONS ASKED BY THE AGENCIES:

- Whether the Agencies should simplify or omit certain of the exclusion's limitations, including those not applicable to registered investment companies ("RICs"), and whether any concerns about evasion should be addressed through the Rule's general anti-evasion authority in Section __.21 of the 2013 Final Rule. The Agencies solicit comment on a number of the exclusion's conditions, including in particular:
  - Whether the condition requiring that a fund/issuer be authorized to sell interests to retail investors in the issuer's "home jurisdiction" should be removed or modified.
  - Whether the exclusion should be modified to focus on whether a fund's interests are authorized for sale to retail investors, or the fund is authorized to conduct a public offering, rather than whether a fund's interests are actually sold in a public offering that includes retail investors.
  - How the Agencies should address funds sold to retail investors through intermediaries in secondary market transactions.
- The compliance challenges and costs banking entities have incurred in achieving compliance with the condition that the fund's interests be sold "predominantly" to non-U.S. residents and, for U.S. banking organizations, predominantly to persons other than the sponsoring banking entity and certain affiliated persons and their family members.
- Whether the different maximum ownership limits for FPFs and RICs applicable to a U.S. banking entity that sponsors the FPF (i.e., post-seeding period, less than 15% for FPFs and less than 25% for RICs) is appropriate.

OBSERVATIONS:

- The Agencies devote 14 pages of the Proposal to discussing and posing questions regarding the foreign public fund exclusion. While they did not ultimately propose changes to the exclusion, the Agencies' questions largely address the main problems that banking organizations have encountered with the numerous, complex, and in some cases impractical conditions of the current exclusion. The discussion of the exclusion in the Proposal's preamble suggests that the Agencies recognize that several of the exclusion's conditions are simply not practical, and require significant simplification in order for the exclusion to achieve its intended purpose and prevent unnecessary disruption of the non-U.S public fund businesses of both U.S. banking entities and FBOs.
- In addition to addressing each of the problematic provisions on which the Agencies solicit comment, commenters should consider holistically an alternative approach that would be simple, practical to implement and achieve the underlying purpose of excluding vehicles that are sufficiently similar to RICs while providing reasonable protection against perceived opportunities for evasion. For example, commenters may wish to revisit arguments made following issuance of the original proposed rule that certain vehicles, such as UCITS, should be explicitly carved out of the covered fund definition. Similarly, commenters may consider proposing that the Agencies confirm that issuers whose interests are traded on certain types of exchanges should by definition be viewed as foreign public funds.

- As in other areas of the Rule, concerns about evasion appear to have led the Agencies to layer in specific provisions in an attempt to prevent evasion, which inadvertently introduced significant complexities and unintended results. In several parts of the preamble to the Proposal, the Agencies suggest an openness to reconsidering this approach in favor of relying more on their general anti-evasion authority (which can always be exercised through later rulemakings or guidance if needed). Adopting an approach of that type could permit significant simplification of the FPF exclusion and other areas.
- The questions cited above highlight some of the thornier issues that the industry has faced in implementing the FPF exclusion to date, including the apparent requirement that a qualifying issuer actually sell some (unspecified) portion of its interests to retail investors. The policy rationale for such a requirement is not clear, given that regulatory regimes governing public funds (both in the United States and abroad) generally do not depend on the level of actual retail sales, and no such requirement applies to a banking entity's ability to invest in or sponsor a RIC. Similarly, the exclusion's requirement that an issuer be authorized to sell to retail investors in the issuer's home jurisdiction, as opposed to other primary listing or offering jurisdictions, and the challenges around interests sold through intermediaries or in secondary market transactions have also posed significant challenges and should be addressed once more by commenters.
- Commenters will want to consider what data or other information can be provided in support of written advocacy, building on prior submissions regarding the real-world challenges and costs of complying with certain of the FPF exclusion's conditions, perhaps including:
  - Costs incurred in developing and maintaining systems to track compliance with the condition that a qualifying FPF's interests be sold "predominantly" to non-U.S. residents in one or more "public offerings";
  - Where funds are listed on a foreign exchange or are sold through independent distribution platforms, the feasibility of obtaining sufficient information about fund investors; and
  - Costs and resources required to identify and monitor investments in firm-sponsored FPFs by employees or directors firm-wide (including immediate family members and controlled personal investment companies, if applicable).
- The industry has had extensive discussions with staff of the Agencies regarding these issues and proposed approaches to address them on an industry-wide basis in a reasonable, practical manner. While it is disappointing that the Proposal does not include proposed revisions in this area, the Agencies' questions indicate a comprehensive understanding of the specific problems that industry has identified to them, and an openness to finding an appropriate way to address them.

D. Family Wealth Management Vehicles ("FWM Vehicles") – Exclusions From Definition of "Covered Fund"

Summary of Proposed Changes:

- The Agencies do not propose any changes to the treatment of FWM Vehicles, many of which the Agencies assert are currently covered funds by virtue of their reliance on Section 3(c)(1) or 3(c)(7) of the 1940 Act.
- However, the Agencies solicit comment on how FWM Vehicles should be defined, whether such vehicles should be excluded from the definition of "covered fund", and to what extent the incorporation of certain exemptions into the "Super 23A" prohibition would permit banking entities to continue to provide services they have traditionally provided to such vehicles.

Selected Questions Asked by the Agencies:

- Whether the Agencies should exclude FWM Vehicles from the definition of "covered fund", and if so, how such vehicles should be defined and what factors should be considered to distinguish FWM Vehicles from hedge funds or private equity funds.
- Whether the Agencies should define a FWM Vehicle to mean an issuer that would be a "family client," as defined in the SEC's Rule 202(a)(11)(G)-1(d)(4) under the Investment Advisers Act of 1940, and if so, whether modifications to that definition would be appropriate.
- The types of services that banking entities provide to FWM Vehicles, and whether amending the "Super 23A" prohibition to incorporate exemptions provided in Section 23A of the Federal Reserve Act and the Federal Reserve Board's Regulation W would permit banking entities to continue to provide these services.

Observations:

- The Agencies' questions regarding potential changes to address concerns around FWM Vehicles reflect extensive discussions with industry participants on this topic. In particular, institutions have faced potential disruption of the services typically provided to such vehicles due to the Super 23A provision's flat prohibition on covered transactions with a sponsored, advised or managed "covered fund". While compelling arguments have been presented regarding the negative, likely unintended effects on this traditional wealth management / asset management activity, the Agencies have yet to provide formal relief, perhaps due to the challenges of defining the vehicles to be excluded. Commenters have previously proposed an exclusion for FWM Vehicles, and in response to the Proposal will likely focus on the Agencies' questions regarding how to define these vehicles. Commenters will presumably also wish to emphasize the Agencies' authority to carve out vehicles inadvertently swept in to the regulatory definition of "covered fund" by the extraordinarily broad baseline definition of "hedge fund" and "private equity fund" in the statute (which authority the Agencies have of course chosen to exercise to create other exclusions).

E. JVs – Exclusions From Definition of "Covered Fund"

Summary of Proposed Changes:

- The Agencies do not propose any modifications to the existing exclusion for JVs, but solicit comment on whether the purpose and conditions of the exclusion should be clarified further, including by codifying the Agencies' FAQ #15, published in June 2016, which narrowed considerably the types of arrangements that would qualify for the exclusion.

Selected Questions Asked by the Agencies:

- Whether the views expressed by staff in FAQ #15 affect the utility of the JV exclusion, and if so, how the Agencies could increase or preserve the utility of the JV exclusion as a means of structuring business arrangements without allowing an excluded JV to be used by a banking entity to invest in or sponsor what is, in effect, a covered fund that merely has no more than ten unaffiliated investors.
- Whether the Agencies should modify the JV exclusion to clarify staffs' view that a person who does not have some degree of control over the business of an entity would generally not be considered to be participating in "a joint venture between a banking entity or any of its affiliates and one or more unaffiliated persons".

Observations:

- Unlike its initial iteration in the Agencies' 2011 proposed rule, the JV exclusion implemented in the 2013 Final Rule did not require that a qualifying JV be an "operating company".
- Following issuance of the 2013 Final Rule, many market participants interpreted the apparently expanded JV exclusion to be available for jointly-owned entities and arrangements primarily engaged in the business of acquiring and selling instruments other than securities, including loans and loan participations, real estate, commodities and other non-security assets, subject to compliance with the other conditions of the exclusion, such as a limited number of co-venturers.
- In June 2015, however, the Agencies published guidance regarding the intended scope and purpose of the JV exclusion in the form of FAQ #15. Although the Agencies framed the guidance as merely clarifying, many market participants read FAQ #15 as a material revision of the exclusion that was inconsistent with its implementation in the 2013 Final Rule. Some observed that FAQ #15 can be interpreted effectively to restore the "operating company" condition that the Agencies had ostensibly determined to eliminate, citing for example the Agencies' statements in the FAQ that the "limitations in the joint venture exclusion are meant to ensure that the joint venture is not an investment vehicle," but rather "reflect that the exclusion is designed to be used by a banking entity to conduct businesses . . . ."[42]

[42] Volcker Rule: Frequently Asked Questions, FAQ 15 (posted June 12, 2015), available at https://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#15.

- The FAQ was widely viewed as having been issued in reaction to concern about certain tender option bond structures. It was the most controversial of the Agency FAQs to date, and is generally viewed as having gone too far in limiting the scope of the exclusion in a manner inconsistent with the text of and preamble to the 2013 Final Rule.
- Although the Agencies' willingness to reconsider FAQ #15's narrowing of the JV exclusion is encouraging, in related questions in the Proposal the Agencies underscore the significance of certain conditions that are not common in the context of many pooled or similar arrangements with a limited number of participants and a strategy that does not involve trading in or otherwise investing in securities for resale or other disposition. For example, the Proposal refers to the view of Agency staff that any participant in a qualifying JV "have some degree of control over the business of an entity", without clarifying the "degree of control" expected. Commenters may seek to provide examples of structures with very limited "control" rights that should reasonably fall within the exemption and argue for removal or appropriate clarification of the staff view cited.
- By its terms, the joint venture exemption could, for example, be reasonably applied to strategic investments in non-security assets (e.g., a pool of loans) effected through entities that technically rely on 3(c)(1), but which would be permissible for a banking entity to make directly.
- Presumably many commenters will oppose any codification of FAQ #15, and argue that at minimum the scope of the exemption in the 2013 Final Rule should be restored.
- Commenters may seek to leverage the Agencies' question about whether the exclusion has allowed banking entities to be able to share the risk and cost of financing their banking activities through JVs, therefore managing their risk more efficiently. Describing examples where owning interests through a JV structure enables better risk management and highlighting how some common structures could be viewed as inconsistent with the exclusion as currently interpreted may most effectively leverage the stated purpose of the exclusion.

F. Securitizations – Exclusions From Definition of "Covered Fund"

Summary of Proposed Changes:

- The Agencies do not propose any changes to the loan securitization exclusion, but solicit comment on certain notable issues, including whether the exclusion should be amended to permit a loan securitization to hold 5-10% of its assets in the form of **debt securities**, and whether the definition of "ownership interest" should be amended in the context of securitizations.

Selected Questions Asked by the Agencies:

- Whether the addition of a permissible "bond bucket" would be necessary or appropriate now that banking entities have restructured many loan securitizations to comply with the loan securitization exclusion as prescribed in the 2013 Final Rule.
- Whether the Agencies should modify the 2013 Final Rule's definition of "ownership interest" in the context of securitizations, in particular with respect to the first prong of the "other similar interest" definition. The first prong of the "other similar interest" definition captures as an

"ownership interest" any interest that gives the holder "the right to participate in the selection or removal of" a general partner, investment manager, trustee or similar role "(excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event)".[43] The Agencies invite comment on whether they should specify that this parenthetical regarding traditional creditor rights includes the right to participate in the 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.

OBSERVATIONS:

- Among the more controversial aspects of the 2013 Final Rule's definition of the "loan securitization" exclusion was the prohibition on holding debt securities (a so-called "bond bucket"), other than in very narrow circumstances. Many collateralized loan obligations ("CLOs"), CDOs, bond repackagings and other securitizations structured prior to the issuance of the 2013 Final Rule held small components of debt securities (including not only bonds, but also other asset-backed securities). Banking entities were therefore required to divest their interests in such securitizations, attempt to cause existing vehicles to restructure in order to conform to the exclusion, or seek illiquid fund extensions where possible.
- In addition, the ability of banking entities' securitization trading operations to engage in market-making/dealing in interests in non-conforming securitizations that remained covered funds was particularly affected, given that positions in those vehicles were counted toward the Volcker Rule's 3% aggregate ownership limit and capital deduction requirement (an issue addressed separately—see below).
- The Agencies' question of whether a qualifying loan securitization should be permitted a bond bucket of up to 5% or 10% of the vehicle's assets may be less important to U.S. CLO sponsors and investors today than it was when the 2013 Final Rule was released. Many of the older vintages most affected by the exclusion's restrictions have since matured, and the U.S. CLO market has largely moved away from bond buckets since. However, this has not been the case in Europe, and restoration of a permissible bond bucket could promote convergence with European CLO market structures.
- The Agencies' request for comment on a revision to the "ownership interest" definition, in particular the first prong of the "other similar interest" definition that currently captures an otherwise excluded debt security simply because the security confers the right to "participate in the selection or removal of" a collateral manager or other governing party, except following an acceleration event or event of default (the "Voting Prong"), could particularly facilitate sponsorship of and investment in CLOs in the United States (and Europe). As many commenters have observed to the Agencies, the policy basis for capturing as an "equity, partnership or other similar interest" a security that otherwise conforms to the characteristics of simple debt (including for ERISA, tax and other purposes), has never been clear. In the Proposal, the Agencies specifically invite comment on whether it would be consistent with the existing carve-out from the Voting Prong (i.e., the exercise of voting rights as an exercise of creditor's remedies) to permit a holder of a debt security to participate in the removal of a collateral manager or similar party "for cause," or to nominate or

[43] Preamble to Proposal at 189.

vote on a nominated replacement manager upon an investment manager's resignation or removal. If adopted, the presence of this type of "voting right" would not trigger the Voting Prong/ownership interest definition and permit a banking entity to treat the security as debt.

- Market participants should also consider pointing out to the Agencies that a "pure" loan securitization standard permitting not even de minimis (e.g., less than 5%) securities inherently raises compliance costs and excludes a variety of potential structures that should not raise evasion concerns.

G. Potential Treatment of Foreign Excluded Funds As Banking Entities

Summary of Proposed Changes:

- The Agencies do not propose a solution to the problem of certain **foreign non-covered funds** ("foreign excluded funds" or "FEFs") that are "controlled" by an FBO for BHC Act purposes being treated as banking entities and thus subjected to the Volcker Rule's prohibitions and restrictions.
  - Control can arise by virtue of a **governance relationship with** and/or **investment in** the fund.
- However, the Agencies are **extending to July 2019 the current no-action relief** for controlled **"qualifying foreign excluded funds"** ("QFEFs") issued in a policy statement by the Federal Reserve Board, the OCC and the FDIC that was due to expire in July 2018.[44]

  During this extended no-action period:
  - The Agencies will not treat a QFEF as a banking entity or attribute its activities and investments to a banking entity that sponsors or otherwise may control the fund.
  - Agency staff will continue to consider "ways in which the 2013 final rule may be amended, or other appropriate action . . . may be taken, to address any unintended consequences of [the Volcker Rule] for foreign excluded funds".[45]

[44] See "Statement Regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act" (July 21, 2017), available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170721a1.pdf (the "Policy Statement").

[45] Preamble to Proposal at 48.

SELECTED QUESTIONS ASKED BY THE AGENCIES:

- Whether the scope of QFEFs in the Policy Statement is too narrow or too broad, and if any further clarification is required, including with respect to what constitutes a "bona fide asset management business".
- To what extent the proposed revisions to the TOTUS and "solely outside the United States" ("SOTUS") exemptions would adequately address concerns about the potential treatment of FEFs as banking entities, and whether further exemptions could enable such a fund to engage in proprietary trading or covered fund activity notwithstanding its status as a banking entity.
- Whether instead of or in addition to the Policy Statement relief, the Agencies should amend the 2013 Final Rule to permit a banking entity to elect to treat a FEF as a covered fund ("opt in") in order to benefit from the exclusion of covered funds from the definition of "banking entity".
- Whether there are any potentially adverse effects of an opt-in approach, including potential disruptions and extraterritorial impact due to the restrictions in Super 23A and the compliance program requirements, and how such effects should be addressed consistent with the statute.

OBSERVATIONS:

- FBOs, U.S. and international trade groups, foreign government officials, and other stakeholders have urged Agency staff for years to address concerns about the extraterritorial impact of the 2013 Final Rule's treatment of FEFs "controlled" by foreign banking entities.
- Commenters have frequently noted to the Agencies that treating controlled FEFs as "banking entities" without regard to their general lack of nexus to the United States (including the lack of risk to U.S. entities in connection with such funds' non-U.S. activities) extends the extraterritorial impact of the Volcker Rule far beyond the traditional reach of U.S. banking laws and what Congress intended. For example, under Section 4(c)(9) of the BHC Act, foreign banking entities are generally permitted to own 25% or more of or otherwise control funds that operate outside of the United States and have little or no U.S. nexus.
- Many in the industry have provisionally concluded that, absent formal relief, the 2013 Final Rule results in more restrictive treatment of FEFs than covered funds, since a banking entity could control a U.S. hedge fund or private equity fund without the fund being subjected to the Volcker Rule's trading and investment limitations as a result (due to covered funds being carved out from the banking entity definition). There is no apparent policy rationale for more punitive treatment of an FBO's investment in, or sponsorship of, a FEF, particularly where an FBO is explicitly permitted to freely invest in non-U.S. funds if it complies with SOTUS or the Policy Statement. In the absence of regulatory guidance, views regarding the appropriate treatment of FEFs under the Volcker Rule presumably continue to vary widely across affected institutions globally. The Agencies' extension of the no-action period with respect to many foreign funds is certainly helpful in the near-term, as are the proposed modifications of the TOTUS exemption.
- The Agencies appear to be contemplating several alternatives to resolving this issue: (i) simply making permanent the relief in the Policy Statement, in its current form or with some minor modifications or clarifications; (ii) adopting an alternative approach that does not effectively create

an exclusion for certain QFEFs, but instead permits "opting in" to covered fund status to take advantage of the existing exclusion for covered funds; or (iii) adopting neither of these approaches on the theory that the proposed changes to TOTUS and other exemptions make relief on the banking entity issue unnecessary.

- Generally the relief in the Policy Statement has been well-received, but commenters will want to consider any limitations or ambiguities that should be addressed. In particular, commenters have noted in the past that the condition requiring a QFEF to be "established and operated as part of a bona fide asset management business" creates some ambiguity, in particular in relation to some business lines focused on fund-linked products. Since the purpose of this limitation appears to be to prevent banking organizations from seeking to evade the proprietary trading limitations, commenters could consider suggesting removal of this limitation in favor of relying on existing or additional anti-evasion language. Alternatively, the Agencies could confirm in a preamble to the final rule that fund-linked products are part of a bona fide asset management business, insofar as they are a customer-driven asset management product.

- The Agencies also request comment on an alternative approach to the controlled FEF problem, which would permit a foreign banking entity to elect to treat a FEF as a covered fund and thus benefit from the exclusion for covered funds from the banking entity definition. Under this approach, the banking organization presumably would have to rely on an exemption such as SOTUS or the asset management exemption to invest in or sponsor such a foreign fund.[46] The Agencies ask whether only those qualifying FEFs that meet the conditions set forth in the Policy Statement should be permitted to "opt in" under such an approach. One risk with this approach is that alluded to in the Agencies' questions—whether Super 23A or compliance program requirements could be applied in such a way as to disrupt the ordinary course activities of such a foreign fund or unnecessarily add compliance burdens. Given that the Agencies were able to reach consensus on the Policy Statement approach, if commenters have found it largely effective, it may be prudent to focus on any required clarifications or revisions to that approach, and to support the "opt-in" approach only as a potentially useful supplement rather than an alternative approach.

- As suggested by the Agencies' questions, the proposed changes to the TOTUS exemption for offshore trading by foreign banking entities may address some of the concerns about controlled FEFs being treated as banking entities. Concerns about investments of such entities in third-party covered funds (e.g., in the context of a foreign fund-of-funds) were largely resolved by the clarifications in FAQ #13 that effectively permit investments in third-party funds even if they have U.S. investors. The critical problem with subjecting FEFs to the proprietary trading restrictions is that under the 2013 Final Rule, it is frequently impractical or undesirable to rely on TOTUS, in particular due to that exemption's current prohibition on trading with U.S. counterparties. If the Agencies' proposal to remove that limitation on TOTUS is adopted, this would likely resolve those concerns to a significant degree. However, foreign banking entities will want to consider carefully any potential limitations of an approach that treats controlled FEFs as banking entities and relies on compliance with the TOTUS and SOTUS exemptions, including compliance burdens. In particular, where controlled FEFs execute trades through U.S.-based trading personnel, requiring reliance on TOTUS could create disruption. Given these concerns, the strong policy arguments supporting excluding controlled FEFs from the banking entity definition, many of which have been

[46] See 2013 Final Rule, §§ __.13(b), __.11(a).

acknowledged by the Agencies, foreign banking entities may conclude that they should continue to press for some form of permanent relief on banking entity status.

H. Potential Treatment of Employees' Securities Companies ("ESCs") As Banking Entities

Summary of Proposed Changes:

- The Agencies do not propose a solution to the potential treatment of a **controlled ESC as a banking entity**, but they solicit comment on the issue and acknowledge that "treating these ESCs as banking entities . . . may conflict with their stated investment objectives, which commonly are to invest in covered funds for the benefit of the employees of the sponsoring banking entity".[47]

Selected Questions Asked by the Agencies:

- Whether an ESC that is controlled by its banking entity sponsor by virtue of corporate governance arrangements—which is a required condition of the exemptive relief available under § 6(b) of the 1940 Act—but in which the sponsor holds no ownership interest, should be excluded from the definition of "banking entity".
- Whether ESCs should be deemed to make investments "as principal".
- To what extent banking entities invest directly in ESCs, and how the Agencies should consider residual or reversionary interests resulting from employees forfeiting their interests in an ESC.

Observations:

- An ESC does not benefit from the covered fund exclusion from the definition of "banking entity", because ESCs are generally not covered funds due to their reliance on the exemption from the definition of "investment company" available under § 6(b) of the 1940 Act.
- The questions posed by the Agencies in the Proposal are consistent with issues raised in discussions last year between industry participants and staff of the Volcker Rule interagency working group.
- In particular, the questions reflect the Agencies' focus on the nature and extent of banking entity ownership interests in sponsored ESCs, and may suggest that the Agencies are more amenable to providing "banking entity" relief for ESCs that are controlled solely by virtue of governance arrangements, with little or no contributed banking entity capital.
  - For example, in the Proposal the Agencies ask to what extent banking entities invest directly in ESCs; whether an ESC should be "treated differently" if its (controlling) banking entity sponsor also acquires or retains any ownership interest in the ESC; and, if so, how the Agencies should consider residual or reversionary interests forfeited by employees in comparison. It is unclear whether the Agencies deliberately focused on a distinction based on no ownership interest (perhaps consistent with the carveout for acquisitions in a fiduciary

[47] Preamble to Proposal at 54.

capacity) rather than referring to a de minimis interest such as the 3% permitted for sponsored covered funds.

- The Agencies also invite comment on whether ESCs make investments "as principal" for Volcker Rule purposes. The Volcker Rule's proprietary trading and covered fund investment restrictions apply only to activities undertaken by a banking entity "as principal". Accordingly, the activities of a vehicle "controlled" by a banking entity under the BHC Act are not subject to the Volcker Rule's restrictions where not conducted "as principal".
  - For example, in the 2013 Final Rule the Agencies clarified that a number of activities often conducted by banking entity affiliates are excluded from the rule's restrictions because they are not undertaken "as principal", including activities undertaken in a fiduciary capacity for customers and investments on behalf of employees through deferred compensation arrangements, among others.[48] Nothing in the 2013 Final Rule suggests that the specified activities were intended as an exhaustive list of all activities that should not be attributed to a banking entity acting "as principal".
  - The Agencies have in other contexts affirmed that they have the authority not to attribute investments or activities of an entity controlled by a banking entity to the banking entity. For example, the 2013 Final Rule provides that interests held by a controlled RIC, business development company ("BDC") or FPF will not be counted towards the 3% per-fund or aggregate investment limits, even if they are controlled, if the banking entity holds less than 25% of the voting interests of such vehicles. FAQ #14 concludes that the Agencies' staffs would not advise that the activities and investments of certain foreign public funds be attributed to the banking entity for Volcker Rule purposes where the banking entity holds less than 25% of the fund's voting shares, even if controlled for BHC Act purposes.
- The Proposal offers commenters an important opportunity to present reasonable, compelling arguments to Agency staff regarding why some or all ESCs should either be excluded from the definition of "banking entity", formally deemed not to engage in investment activity "as principal" or provide other similar relief. Presumably commenters will seek the flexibility to hold at least a de minimis amount in an ESC (as they can in a covered fund while still benefiting from a banking entity exclusion) and acknowledge that ESC structures often do result in banking entities acquiring ownership interests (e.g., due to an employee's departure) that should generally not change the characteristics of the vehicle for Volcker Rule purposes.
- Commenters should also give careful thought to the Agencies' request for input regarding any other investment vehicles or entities that might appropriately (i.e., "consistent with the statute") be excluded from the definition of "banking entity". In particular, the Agencies ask for any other examples of investment vehicles or entities that invest on behalf of employees and in which banking entities invest as principal, offering the examples of deferred compensation plans such as rabbi trusts.

[48] See 2013 Final Rule, § __.10(b).

I. Permitted Seeding Period for RICs, BDCs and FPFs

Summary of Proposed Changes:

- The Agencies do not propose any changes to the guidance in FAQ #16 confirming that **RICs and FPFs will not be treated as banking entities** during an appropriately limited seeding period, and that the Agencies do not expect an application to be submitted to the Federal Reserve Board to determine the length of the seeding period.
- The Agencies reiterate that, in the FAQ #16 guidance, the staffs stated their understanding that the seeding period for a RIC or FPF "may take some time" and "can vary", and that the guidance did not "specify[] a maximum period of time" for such seeding periods.

Selected Questions Asked by the Agencies:

- Whether there is uncertainty about the length of permissible seeding periods for RICs and FPFs, despite the Agencies not having specified a maximum period of time in published guidance.
- Whether they should adopt an approach that specifies a maximum seeding period to provide further clarification, and if so, what an appropriate maximum time period would be.
- Whether there are circumstances that may result in a banking entity sponsor's investment in a RIC or FPF exceeding 25% after the seeding period, such as in anticipation of liquidation or following a large investor redemption.

Observations:

- The tone of the Agencies' discussion of the length of permitted seeding periods for RICs and FPFs (and BDCs), as well as the accompanying questions posed for comment, suggest that the Agencies believe they have provided sufficient clarity on the question in FAQ #16. They open the door to commenters who wish to advocate for a specified period of years for a permitted seeding period. However, industry participants will want to weigh carefully the benefits of additional clarity versus the potential inflexibility of a specified period of years. It may be difficult to identify a set period that would be appropriate for funds of different profiles, across markets, etc. In addition, a defined seeding period may not accommodate idiosyncratic fact patterns that can arise and be reasonably addressed within the current FAQ guidance.
- The Agencies' questions about scenarios where a banking organization sponsor may temporarily hold a greater than 25% interest after the seeding period create an opportunity to advocate for flexibility in those circumstances, which have presented challenges for banking organizations under the 2013 Final Rule.

J. Underwriting And Market-Making Exemption

Summary of Proposed Changes:

- The Proposal would eliminate the application of the 3% aggregate limit and capital deduction requirement to ownership interests in third-party covered funds held by a banking entity in reliance on the underwriting or market-making exemptions.
- The Agencies also proposed to eliminate applicability of the 3% per-fund limit to positions in third-party covered funds acquired in a market-making or underwriting capacity where a banking entity "guarantees, assumes or otherwise insures the obligations or performance" of such third-party fund.
- The 3% aggregate (and per-fund) limits and capital deduction requirement would continue to apply to underwriting or market-making positions in covered funds that a banking entity sponsors, advises, or organizes and offers as described in Section __.11(a) or (b).
  - Although in the preamble, the Agencies describe the proposed underwriting/market-making relief as limited to positions in covered funds that a banking has not "organized and offered", the text of the proposed rule provides that the relief is not available with respect to covered funds for which a banking entity (i) acts as sponsor; (ii) acts as investment adviser or commodity trading advisor; (iii) relies on the Section __.11(a) asset management exemption to acquire or retain an ownership interest or (iv) relies on the Section __.11(b) securitization exemption (whether as securitizer or risk retainer) to acquire or retain an ownership interest.

Selected Questions Asked by the Agencies:

- Whether the Agencies should consider any other changes to more closely align the requirements for engaging in underwriting or market-making-related activities with respect to covered funds with the requirements for engaging in those activities with respect to other financial instruments.
- Whether the Agencies should exempt ownership interests in <u>all covered funds</u> held pursuant to the underwriting and market-making exemptions from the 3% per-fund and aggregate limits, and the capital deduction, rather than only exempting interests acquired in third-party funds from those requirements.

Observations:

- The Agencies' proposal to exempt underwriting and market-making positions in third-party covered funds (including securitizations) from the existing 3% aggregate limit and capital deduction requirement arguably represents the most significant element of the Proposal with respect to covered funds. Elimination of the 3% per-fund limit applied under the exemptions to guaranteed funds also helpfully eliminates a limit that had proven problematic and led to seemingly unintended results in practice.
- The change would greatly improve the utility of the market-making exemption in particular, and provide significant relief for covered funds compliance burdens in the secondary markets in particular. The most challenging and costly requirements to evaluate covered fund status have

arisen in the context of dealer trading and market-making activity, which is generally conducted pursuant to the market-making exemption, where it is often especially difficult to assess an issuer's covered fund status.

- Although acquisition of covered fund interests were permissible in reliance on the exemptions, such interests still had to be identified for purposes of the aggregate limit and capital deductions.
- The industry engaged in massive compliance projects, individually and collectively, to attempt to address these challenges, but they continue to create uncertainty and impose significant compliance costs. The restrictions also discouraged market-making activity in such instruments in practice.

- If adopted, the change would substantially reduce the importance of identifying whether a particular issuer in which a banking entity acquires an interest in compliance with the proprietary trading exemptions for market-making or underwriting is a covered fund, so long as it is a third-party fund. If it is a related fund, some of the identification challenges are easier to address (though still burdensome and in some cases difficult). In addition to reducing compliance burdens, this proposed change would diminish the urgency of narrowing the overbreadth of the covered fund definition. The proposed change would be an elegant and simple means of addressing some of the most troublesome aspects of that overbreadth, in a manner consistent with the statute and without requiring perfect fixes to definitional challenges.
- Commenters will certainly want to take up the question of whether the same relief should be extended to related funds. In prior comments, industry participants had advocated for this relief to apply to all covered fund interests held under the underwriting and market-making exemptions.[49] The policy rationale generally should apply equally to market-making or underwriting in related funds. If the Agencies' rationale for limiting the relief is to avoid potential evasion, commenters could urge the Agencies to rely on their broad anti-evasion authority to address any abuse.
- To give the proposed changes practical effect, it will also be important for any formal or informal recordkeeping requirements or expectations to be flexible enough to track the changes. In other words, if the amended rule permits a banking entity to trade in third-party (or related) securitizations, whether they are covered funds or not, as long as the banking entity complies with the market-making exemption, it should not be necessary to maintain records to support whether the securitization is a covered fund (since that status is no longer relevant). Otherwise, the intended benefits of the expanded exemption would be undermined.
- The Proposal would retain the existing detailed covered fund documentation requirements in Section __.20(e) of the 2013 Final Rule for institutions with significant TAL (see Section III below). While those generally apply to covered funds sponsored or seeded by a banking entity, U.S. banking entities are required to calculate interests held in foreign public funds if such interests exceed $50 million. Given the challenges of differentiating between a foreign public fund and a covered fund in the market-making context, commenters may wish to highlight this as a requirement that should be removed to effectuate the Agencies' intent to remove obstacles to permissible market-making activity.

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[49] See, e.g., Securities Industry and Financial Markets Association, *supra* note 41, at C-86.

K. RISK-MITIGATING HEDGING EXEMPTION FOR COVERED FUNDS

SUMMARY OF PROPOSED CHANGES:

- The Proposal would restore the exemption provided for in the Agencies' 2011 proposed rule permitting a banking entity to **hold a covered fund interest as a risk-mitigating hedge where acting as an intermediary on behalf of a customer** (that is not itself a banking entity) to facilitate the customer's exposure to the fund.
  - This change would undo the controversial "high-risk trading strategy" guidance in the preamble to the 2013 Final Rule that had severely limited **fund-linked products businesses**.
- The Proposal would retain the existing exemption's authority to hedge certain employee compensation arrangements.

SELECTED QUESTIONS ASKED BY THE AGENCIES:

- What kinds of transactions a banking entity would enter into to facilitate the exposure by a customer to the profits and losses of a covered fund.
- What types of covered fund ownership interests a banking entity would acquire or retain to hedge a customer, how such an ownership interest would operate as a hedge and what kinds of customers would be involved.
- Whether the Agencies should place additional limitations on these arrangements, such as a requirement for a banking entity to take prompt action to hedge or eliminate its covered fund exposure if the customer fails to perform.

OBSERVATIONS:

- As introduced in the Agencies' 2011 proposed rule, the covered fund risk-mitigating hedging exemption would have permitted a banking entity to hold ownership interests in covered funds in order to hedge the banking entity's obligations arising from its role as an intermediary facilitating a non-banking entity customer's exposure to the profits and losses of the covered fund.
- But in adopting the 2013 Final Rule, the Agencies chose not to retain this element of the covered fund hedging exemption, stating in the accompanying preamble that "transactions by a banking entity to act as principal in providing exposure to the profits and losses of a covered fund for a customer, even if hedged by the entity with ownership interests of the covered fund, is a high risk strategy that could threaten the safety and soundness of the banking entity".[50] This characterization of a common customer-driven transaction as a high-risk trading strategy was apparently intended to discourage banking entities from engaging in the business entirely. Although not expressly addressed in the relevant preamble discussion accompanying the 2013 Final Rule, the Agencies' determination to eliminate the proposed exemption for hedging so-called 'fund-linked products' and similar arrangements was viewed by many industry observers as an exercise of the Agencies'

[50] 2013 Final Rule, 79 Fed. Reg. at 5737.

authority to deem an otherwise permissible activity to be prohibited under the Volcker Rule's "backstop" provisions.[51]

- The Agencies also noted a concern in the preamble to the 2013 Final Rule that the initial iteration of the covered fund hedging exemption could have been used to evade limits on exposure to covered funds.
- In the same preamble, the Agencies acknowledged the likely impact of the narrowed covered fund hedging exemption on banking entities' fund-linked products businesses, noting that the Agencies "recognize that U.S. banking entities may no longer be able to participate in offering customer facilitation products relating to covered funds".[52]
- The narrowing of the proposed covered fund hedging exemption in the 2013 Final Rule was particularly curious given the Agencies' (appropriate) determination to carve out margin financing secured by covered fund interests from the Super 23A prohibition, yet deem "high risk" the economically similar arrangement of a total return swap on a covered fund hedged with an ownership interest in the fund.
- The Proposal would restore the covered fund hedging exemption as proposed in 2011, permitting a banking entity, acting as a customer-facing intermediary, to hold ownership interests in a covered fund in order to hedge the exposure to the fund that the banking entity facilitates for a customer.
- This relief if adopted would be particularly important for fund-linked product businesses and other contexts where a banking organization is seeking to facilitate customer exposure to a covered fund through a synthetic interest, and the banking organization needs to acquire covered fund interests to hedge its risk.
- At the same time, more subtle issues will remain, such as the manner in which the hedging exemption interacts with a banking entity's reliance on the market-making or other exemptions from the proprietary trading restrictions for the customer-facing derivative itself.

[51] 2013 Final Rule § __.15(a)(2).

[52] 2013 Final Rule, 79 Fed. Reg. at 5737.

L. SOTUS Exemption – Permitted Covered Fund Activities And Investments of A Foreign Banking Entity

Summary of Proposed Changes:

- As in the proposed revision of the TOTUS exemption, the financing restriction prohibiting a **foreign banking entity** from receiving financing from its U.S. branch or affiliate for the purchase or sale of ownership interests in covered funds would be eliminated from the SOTUS exemption.
- The Proposal would incorporate into the regulation the relief in FAQ #13 clarifying that an FBO may rely on the SOTUS exemption to invest in third-party covered funds sold into the United States because the "marketing restriction" prohibits an FBO from participating in an offering targeting U.S. persons (including serving as sponsor or investment adviser to the fund) but does not prohibit offers or sales by a third party.

Selected Questions Asked by the Agencies:

- Whether the Proposal's implementation of the SOTUS exemption is effective and clear, in particular, whether it is clear when a transaction or activity will be considered to have occurred "solely outside the United States".
- Whether the SOTUS exemption, as modified in the Proposal, is consistent with limiting the extraterritorial reach of the Volcker Rule with respect to FBOs, and whether it creates competitive advantages for FBOs in comparison to U.S.-headquartered banking organizations.

Observations:

- FAQ #13, which the Agencies propose to codify into the regulation, was one of the most important interpretative clarifications in the FAQs, with significant business implications for the non-U.S. operations of FBOs. It clarified the ability of FBOs (including some sovereign wealth funds) subject to the Volcker Rule to retain portfolios of third-party private equity fund interests representing billions of dollars of investment and avoided disruptions of non-U.S. fund investments going forward.
- It is unclear what motivated the Agencies to propose removing the U.S. financing restriction from SOTUS. The change is logically consistent with the change to the TOTUS trading exemption, but it is not clear that the U.S. financing restriction has raised the same complications in the SOTUS context as in the TOTUS context. The change is likely to be uncontroversial and could be helpful in some cases.

M. Super 23A

Summary of Proposed Changes:

- The Agencies proposed only one change to the 2013 Final Rule's Super 23A provisions, clarifying that the annual **CEO certification** required in connection with engaging in permitted prime brokerage transactions with second-tier covered funds must be provided no later than March 31 of each year.
- Although not reflected in the proposed revised rule text of the Super 23A provisions, the preamble to the Proposal states that the other four Agencies "do not object" to the CFTC's March 2017 no-action relief allowing an FCM affiliated with a banking entity to provide futures, options and swaps clearing services to related covered funds without violating Super 23A.[53]

Selected Questions Asked by the Agencies:

- Whether Super 23A should be amended to incorporate some or all of the exemptions in Section 23A of the Federal Reserve Act and the Federal Reserve Board's Regulation W (e.g., for intraday extensions of credit in connection with clearing and settlement activities and certain lending transactions fully secured by U.S. government securities or cash collateral).
- Whether to incorporate in some manner the quantitative limits in Section 23A of the Federal Reserve Act and Regulation W.

Observations:

- Incorporation of the exemptions in "normal" Section 23A into Super 23A has long been urged by the industry and is expected to be strongly supported in comments on the Proposal.
- The Volcker Rule statute provided that Super 23A prohibits a banking entity from entering into a transaction with a related covered fund if the transaction "would be a covered transaction, as defined in Section 23A of the Federal Reserve Act." Many commenters pointed out that this language is best read to encompass both the basic list of "covered transactions" in Section 23A and the exemptions from that list codified elsewhere in the same statute and in the Federal Reserve Board's Regulation W.
- The Agencies' question about incorporating the quantitative limits in Section 23A and Regulation W into Super 23A does not clarify how those limits would be calculated. However, to the extent that the quantitative limits were to replace the flat prohibition in the current rule, the change would provide banking entities with welcome additional flexibility.
- Replacing a flat prohibition with quantitative limits could relieve some pressure from questions about the scope of "covered transactions", including areas where written Federal Reserve Board guidance has been sparse (e.g., whether spot FX transactions should be considered purchases of assets).

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[53] Preamble to Proposal at 212.

- At the same time, a quantitative limit approach would not eliminate the need to incorporate the exemptions from "normal" 23A, and ideally the two changes could be adopted together.

- The Proposal does not provide clarification or solicit any comment regarding whether Super 23A could be interpreted to apply extraterritorially to foreign banking entities that sponsor or advise covered funds offshore. The 2013 Final Rule appears to permit FBOs to provide an attestation covering only their U.S. operations.

III. COMPLIANCE PROGRAM

A. TIERED COMPLIANCE PROGRAM REQUIREMENTS

SUMMARY OF PROPOSED CHANGES:

- The Proposal would establish a **three-tiered compliance regime keyed to a consolidated measure of a banking organization's trading assets and liabilities** ("TAL"), applicable to all affiliates and subsidiaries and modified in certain respects for FBOs, as follows:
  - **Significant** TAL: TAL of **$10 billion or more**.
    - For U.S.-headquartered banking organizations, TAL would be calculated on a worldwide consolidated basis.
    - For FBOs, the $10 billion threshold would be calculated based on the TAL of the FBO's combined U.S. operations.
    - Banking organizations with significant TAL would remain subject to the six-pillar compliance program (currently set forth in Section __.20(b) of the 2013 Final Rule), metrics reporting requirements (proposed to be modified, as discussed below), the covered fund documentation requirements (currently set forth in Section __.20(e) of the 2013 Final Rule) and the CEO attestation requirement.
  - **Moderate** TAL: TAL from **$1 billion up to $10 billion**.
    - For U.S.-headquartered banking organizations, TAL would be calculated on a worldwide consolidated basis.
    - For FBOs, the $1 billion threshold would be calculated on a worldwide consolidated basis—i.e., an FBO would look to U.S. operations TAL for determining whether it falls in the "significant" or "moderate" tier, but to **worldwide** TAL to see if it qualifies for the "limited" tier.
      - The Agencies indicated in the preamble that this distinction was intentional, reasoning that it may not be appropriate for FBOs with significant worldwide trading operations to benefit from the "presumption of compliance" even if the TAL for their combined U.S. operations is small.
      - Banking organizations with moderate TAL would only be subject to the simplified compliance program requirements (currently described in Section __.20(f)(2) of the 2013 Final Rule, and previously only available to institutions with $10 billion or less in

total consolidated assets), and the CEO attestation requirement. As a result, these institutions would not be required to implement the specific six-pillar compliance program, but could instead satisfy the compliance program requirement by including in existing compliance policies and procedures references to the Volcker Rule requirements as appropriate given the activities, size, scope and complexity of the organization.

- **Limited** TAL: TAL of **less than $1 billion**, calculated on a worldwide consolidated basis. Banking organizations with limited TAL would benefit from a new rebuttable presumption of compliance. Such institutions would no longer be subject to a compliance program requirement, and "would have no obligation to demonstrate compliance [with the Volcker Rule] on an ongoing basis… unless and until the appropriate Agency, based upon a review of the banking entity's activities, determines that the banking entity must establish the simplified compliance program."

- For all three tiers, TAL would be calculated as the average gross sum of TAL over the previous consecutive four quarters, as measured on the last day of each quarter, and would exclude TAL involving obligations of or guaranteed by the United States (or any agency of the United States).
- Institutions with no covered activities (other than permitted trading in U.S. government securities) remain exempt (pursuant to the 2013 Final Rule) from the compliance program requirements until such time as they begin engaging in covered activities.
- Separately, amendments to the Volcker Rule's statutory text made in the **Economic Growth, Regulatory Relief, and Consumer Protection Act** (Pub. L. 115-174; enacted May 24, 2018) (the "2018 Regulatory Relief Act") also exempt completely from the Volcker Rule all institutions with:
  - $10 billion or less in total consolidated assets, and
  - TAL of 5% or less of total consolidated assets.[54]

  These statutory changes are immediately effective, and the Agencies have indicated they intend to reflect this statutory exemption through a separate rulemaking.
- The Proposal would eliminate the prescriptive Appendix B "enhanced compliance program" requirements now applicable to large banking organizations (those with total consolidated assets of $50 billion or more, or TAL of $10 billion or more) under the 2013 Final Rule, other than the CEO attestation requirement, which is retained for institutions that have significant or moderate TAL (see below).

SELECTED QUESTIONS ASKED BY THE AGENCIES:

- The Proposal includes numerous questions regarding whether the proposed changes effectively reduce the cost and complexity of compliance with the Rule, while still ensuring that the regulations are "effective" at "ensuring robust compliance", and whether there are alternative or additional steps the Agencies can take to further those goals.

[54] The statute does not specify how these thresholds are measured for FBOs.

- Other questions invite comment on whether the Agencies have appropriately defined the scope of application of the full six-tier compliance program, and whether other aspects of the Appendix B "enhanced compliance program" from the 2013 Final Rule should be retained in some form.

- Several questions invite specific comments on whether application of the Volcker Rule, or its compliance program requirements, should be further tailored or adapted for affiliates of banking organizations, such as broker-dealers and investment advisers, that may operate on a separate and independent basis from their parent and affiliates. A related question inquires as to how registered investment advisers currently meet their compliance program obligations, particularly related to prohibitions on covered funds, and what compliance costs are incurred.

OBSERVATIONS:

- The introduction of a three-tier tailored compliance program framework, and the related relief from certain compliance program and documentation requirements under the market-making, underwriting and hedging exemptions for banking entities that do not have significant TAL, would significantly reduce compliance requirements and burdens, with significantly more relief for those institutions with significant TAL.
  - The presumption of compliance for limited TAL banking entities is intended to reduce compliance costs. However, the Agencies note that "a certain level of resources" may be required for an organization to respond to supervisory requests in the event an Agency decides to seek to rebut the presumption of compliance. Thus, even limited TAL banking entities may find that they need to evaluate their activities and maintain compliance policies and processes sufficient to defend a conclusion that they are not engaged in impermissible activities in the event of a supervisory challenge.
  - In addition, the Proposal would not eliminate the threshold analytical burden on smaller banks to determine the compliance tier for which they are eligible (moderate, limited or no covered activities), even though the Agencies took note of public comments asserting that this can require significant analysis for small banking entities.
- The three-tiered structure introduces a certain amount of complexity in how the lowest tier delineation is calculated. While the $10 billion dividing line between the "significant" and "moderate" tiers is based on global TAL for U.S. banking entities and total U.S. TAL for FBOs, the $1 billion dividing line for the "limited" tier is based on global TAL for all entities covered by the Volcker Rule. This change is expected to make it more difficult for FBOs to reduce compliance requirements under the Volcker Rule even if their U.S. footprint is small and does not encompass trading activities.
- The FDIC's staff memorandum released in connection with the Proposal confirms that, as a consequence of shifting the thresholds for compliance tiers from a test based primarily on total assets to a test based on TAL, some institutions that had previously been subject to the enhanced compliance program framework (including CEO attestation) would now be treated as limited TAL entities entitled to the presumption of compliance, but certain moderate TAL entities that had <u>not</u> previously been subject to the enhanced compliance program framework would be required to provide the CEO attestation for the first time (see our observations in Section III.B below).

- The relaxation of compliance program requirements may also, in practice, be "too little, too late" for many institutions. The industry has expended substantial time and resources in developing and implementing the highly prescriptive compliance programs required by the 2013 Final Rule.
  - There may not be much appetite to revisit those programs on a wholesale basis to reflect a new, more flexible compliance framework, especially since banking entities (other than those exempted by the 2018 Regulatory Relief Act) will continue to be subject to the substantive requirements of the Volcker Rule and any changes to compliance policies may become the subject of focus in future examinations.
  - However, the additional flexibility may make it easier for banking entities to tailor and refine their existing compliance frameworks on an incremental basis to reflect lessons and experiences gained through the process of implementing and operating under their existing programs.
  - As discussed in Section II.J above, one specific point that U.S. banking organizations should consider for comment with respect to the remaining compliance program requirements in Section __.20 is the requirement to track interests in foreign public funds. To give effect to the relief provided with respect to market-making and underwriting of covered fund interests, commenters may argue that U.S. banking entities should not be required to definitively determine whether an interest they permissibly hold is a foreign public fund as opposed to a covered fund interest.

B. CEO Attestation

Summary of Proposed Changes:

- The CEO attestation requirement would apply to all banking entities with **significant or moderate TAL**, which could capture some FBOs that have not previously been subject to the CEO attestation requirement under the existing thresholds in the 2013 Final Rule, which applied the attestation requirement to institutions with more than $50 billion in total U.S. assets.
- The Proposal would **eliminate the prescriptive requirement** that the CEO attest that the banking entity has in place processes to "establish maintain, enforce review, test, and modify" the compliance program, while retaining the more general requirement that the CEO attest that the banking entity has in place processes "reasonably designed" to comply with the Rule.

Selected Questions Asked by the Agencies:

- Costs and burdens associated with preparing the CEO attestation, and how significant the costs are relative to the potential benefits.
- Whether the CEO attestation requirement is redundant, and whether any alternatives to the CEO attestation requirement would achieve the same result while reducing compliance burdens.
- Whether existing business practices and procedures or other regulatory requirements render the CEO attestation unnecessary.
- Whether the proposed scope of application of the CEO attestation requirement is appropriate.

OBSERVATIONS:

- The current CEO attestation requirement applies only to those institutions subject to the enhanced compliance program requirements of Appendix B (i.e., those banking entities either (i) subject to the metrics reporting requirements because they have over $10 billion in global (for U.S. firms) or U.S. (for FBOs) TAL or (ii) that have $50 billion or more total global (for U.S. firms) or U.S. consolidated assets (for FBOs)). The proposed revisions to the CEO attestation requirement would subject banking entities that have over $1 billion in global TAL to this requirement. The FDIC's staff memorandum confirms that some banking entities are likely to become subject to the CEO attestation requirement for the first time, whereas others may now be exempted.
  - For U.S. top-tier banking entities, this proposed change could require entities with less than $50 billion of total consolidated assets, but greater than $1 billion in TAL, to begin the CEO attestation process. In practice, however, we would expect such a situation to be rare for U.S. top-tier banking entities with less than $50 billion of total consolidated assets, as such banking entities tend not to house significant trading businesses.
  - For FBOs, these changes are more likely to have a negative effect for some institutions. There are likely to be several FBOs that have less than $50 billion in U.S. total assets, but have greater than $1 billion in global TAL. Indeed, there are likely to be several FBOs with quite small footprints, and potentially no trading operations, in the United States, that nevertheless would become subject to the proposed CEO attestation requirement.
  - Some commenters will argue that a Proposal designed to reduce burdens and increase flexibility should not increase compliance burdens, particularly for institutions with a limited U.S. footprint.
- From the perspective of the industry, the CEO attestation requirement has been viewed as one of the more onerous aspects of the Volcker Rule's compliance framework, due to the internal certification framework, operational requirements and potential duplication of compliance and audit procedures needed to support the attestation. The Proposal seems to suggest, however, that it still has substantial support within the Agencies and is a less likely area for relief. Notably, both Federal Reserve Board Governor Brainard and FDIC Chairman Gruenberg mentioned the CEO attestation requirement as an important reason for why they supported the Proposal, and it was one of ten recommendations the Financial Stability Oversight Council made to the Agencies in 2011. The preamble to the Proposal also suggests that the continued use of a CEO attestation creates an appropriate balance between the proposed simplification of compliance program requirements (e.g., through elimination of the other enhanced program requirements in Appendix B) and the need to ensure that compliance programs are reasonably designed to ensure compliance.
- Unfortunately, the Proposal fails to provide clarity on a number of issues surrounding the scope and content of the CEO attestation requirement that have been briefed and discussed with Agency staff. Such questions include clarifying which entities in a consolidated organization must provide attestations and to which Agencies and whether a CEO's attestation may be qualified based on the CEO's knowledge or another standard of reasonableness. For FBOs, confirmation that an attestation is not required with respect their non-U.S. operations would have been welcomed. Under the 2013 Final Rule, a CEO of an FBO's U.S. operations may provide a limited attestation, though some FBOs provide attestations from parent CEOs covering both U.S. and non-U.S.

operations. None of these topics is raised in the Agencies' questions. Certain statements in the preamble of the Proposal and its supporting economic analysis suggest the Agencies intend for there to be some flexibility in how the attestation requirement is implemented, but the Agencies did not reflect that view in the proposed revisions to the regulatory text.

- Although not reflected in specific questions in the Proposal, the SEC's economic analysis suggests that the Agencies have considered whether to allow additional flexibility, such as substituting a different senior officer for the CEO in the attestation requirement, suggesting there may be further opportunity for advocacy on this issue.

C. METRICS REPORTING

SUMMARY OF PROPOSED CHANGES:

- The Proposal would limit the **scope of application** of metrics reporting by l**imiting which trading desks are required to report certain metrics**. For example, the new requirements to report Positions, Transaction Volumes, and Securities Aging Inventory would **only apply to trading desks engaged in underwriting and market-making activity.**
- Certain metrics reporting requirements would be **revised and simplified** (described in Table III.B below).
- The Proposal would create certain new reporting requirements, specifically:
  - **Descriptive information about each trading desk**, its trading strategy, financial instruments it trades and where it books trades; and
  - **Descriptive information about reported metrics**, in particular:
    - Information schedules providing descriptions of risk and position limits, risk factor sensitivities and risk factor attributions reported under the Comprehensive Profit and Loss Attribution metric;
    - Cross-reference schedules that describe relationships between: (i) risk and position limits and risk factor sensitivities and (ii) risk factor sensitivities and risk factor attributions; and
    - A narrative statement describing any changes in calculation methods used and the reasons for the changes (or report that a banking entity has not made any changes, if applicable).
- Banking entities would be permitted to **retain the option (but not the obligation)** to **include other types of permitted trading** within their covered trading activities and metrics reporting, such as trading related to liquidity management, fiduciary transactions and riskless principal transactions; trading by a regulated insurance company; and trading under the TOTUS exemption by an FBO.
- The Proposal would **extend the timeframe** within which banking entities with **TAL of $50 billion or more** are required to report metrics from 10 days after the end of each month to 20 days. Other banking entities would continue to be required to file within 30 days after the end of each quarter.
- All banking entities would be required to use a standardized **reporting format**, based on **XML Schema**, to be promulgated by each Agency.

SELECTED QUESTIONS ASKED BY THE AGENCIES:

- The Agencies invite comment on each proposed change to the metrics reporting framework, including what costs and burdens are expected to be incurred, what staff and infrastructure requirements would be expected, whether the new requirements are clear, what frequency of reporting is appropriate and whether there are alternatives that may reduce the cost and complexity of compliance while still ensuring that the metrics reporting enables the Agencies to effectively monitor compliance with the Volcker Rule.
- What time would be needed to develop or modify systems and processes to comply with the new reporting requirements, including the timing for implementation of an XML reporting system, and on costs associated with switching to an electronic XML reporting system.
- Whether certain metrics should be publicly available, on a per-entity or aggregate basis, and asks a number of sub-questions about how such a release of information could be accomplished.

OBSERVATIONS:

- The proposed changes to the metrics section reflect a fine tuning, rather than a fundamental rethinking, of the metrics reporting and monitoring model introduced in the 2013 Final Rule. Although one question asks whether metrics reporting should be eliminated in favor of a different approach to monitoring compliance, the Agencies appear committed to using metrics reporting to monitor compliance with the Volcker Rule's substantive prohibitions, rather than making a more fundamental paradigm shift towards reliance on banking entities' own internal policies and procedures. However, the Agencies continue to assert in the Proposal's regulatory text that the reporting framework is not intended to be a "dispositive tool for identifying permissible or impermissible activities".
- The Agencies explain that the proposed changes to metrics requirements reflect an evaluation of the effectiveness of the metrics reporting framework introduced in the 2013 Final Rule and the Agencies' experience with metrics reporting to date. Among other things, the proposed changes are designed to reduce "compliance-related inefficiencies", streamline metrics reporting requirements and standardize metrics reporting practices to improve data quality and consistency. The Agencies also suggest that they intend to continue to evaluate the effectiveness of the metric reporting regime and may propose further changes in the future.
- Although the stated goal of the Agencies is to streamline and reduce inefficiencies, many of the changes will increase compliance costs for reporting banking entities in the near term as reporting systems are revised and rebuilt to meet the new and changed requirements
- The requirement to identify and report qualitative and descriptive information about trading desks and quantitative metrics may prove to be a larger and more complex undertaking than the Agencies anticipated. Although much of the information is presumably reflected in desk or enterprise-wide policies and subject to examiner review, collecting and submitting the information to regulators in a centralized, standardized format is likely to require substantial effort. It may raise concerns about how the data will be used, particularly if it will be used for horizontal reviews and comparisons across banking entities.

- The number of questions in the metrics section suggests, however, that the Agencies are open to further revisions, and constructive, well-substantiated comments could result in helpful revisions and refinements to ease unjustified compliance burdens and costs.

D. USE OF "PRESUMPTIONS OF COMPLIANCE" IN THE PROPOSAL

SUMMARY OF PROPOSED CHANGES:

- The Proposal includes three separate "**presumptions of compliance**":
  - a presumption of **exclusion of "accounting-prong-only**" trading desks from the trading account if the desk's portfolio does not exceed the absolute P&L $25 million threshold;[55]
  - a presumption of **compliance with the RENTD requirements** of the market-making and underwriting exemptions if a trading desk operates within internally-set risk limits;[56] and
  - a **presumption of compliance** with the Volcker Rule generally for banking entities with **limited TAL**.[57]

SELECTED QUESTIONS ASKED BY THE AGENCIES:

- The Proposal requests comment on whether the presumptions of compliance related to the accounting prong should be crafted as a "safe harbor".

OBSERVATIONS:

- The presumptions of compliance are explicitly intended to reduce compliance burden, especially for institutions with limited trading activities.
- However, as currently drafted, the procedures for rebutting the presumptions vary, and in some cases there are questions whether the presumption may turn out to be less useful in practice than it appears in concept. Commenters should review each potentially relevant presumption and consider how it would be implemented in practice by all three lines of defense, as there may be ways to improve the efficiency and workability of the presumptions for both banking entities and the Agencies.
- The presumption of compliance for banking entities with limited TAL has a pre-determination process, requiring the Agency to provide notice to the banking entity of its determination to rebut the presumption, to allow for response by the banking entity and to consider whether to maintain its original determination. Although the rule text does not include mention of a post-determination conformance period, the preamble to the Proposal suggests that some period of time would be contemplated following a rebuttal: A "banking entity would be expected to remediate any impermissible activity upon being notified of such determination by the Agency. A banking entity

[55] See Proposal, § __.3(c).

[56] See Proposal, §§ __.4(a)(8), __.4(b)(6).

[57] See Proposal, § __.20(g).

would be required to remediate the impermissible activity within a period of time deemed appropriate by the relevant Agency."[58]

- o Banking entities may wish to consider whether some more explicit assurance that banking entities would have a reasonable period of time to conform should be included in the final rule (i.e., since the current preamble simply suggests that the Agency would specify the appropriate period of time).
- o How banking entities perceive this conformance issue may depend on their expectations and their experience with the staffs of the most relevant Agency or Agencies in matters of discretion like the one contemplated in this context.

- Because of the differences in application of each of the presumptions, commenters should consider whether each presumption and rebuttal process has been appropriately tailored to the compliance risks under the Volcker Rule it was intended to address. Selected issues relevant to commenters' review include:
  - o Because each presumption is rebuttable, there is a possibility that a rebuttal would trigger a requirement to comply with the Rule's still-complex set of conditions, policies, procedures and recordkeeping. It is worth considering whether a requirement for a reasonable post-determination remediation or conformance period should appear in the rule text for each of the presumptions (and not just the presumption for limited TAL entities, where the preamble suggests at least a potential conformance period).[59]
    - Furthermore, particularly in relation to the proposed accounting prong and its accompanying rebuttable presumption of compliance, questions are raised by the language of the rebuttal notice provided by the relevant Agency ("[Agency] has determined that one or more of the banking entity's activities violates" the proprietary trading prohibitions).[60] In conjunction with a reasonable post-determination conformance period, commenters should consider requesting that determinations by the relevant Agency should not be deemed "violations" but deemed supervisory matters requiring conformance.
  - o The fact that the rebuttal processes across the three presumptions are not consistent could add to the ambiguities about how the presumptions would be applied in practice. For example, the rebuttal process described in relation to the proposed accounting prong (Proposal, Section __.3(c)) states merely that "[t]he [Agency] may rebut the presumption of compliance . . . by providing written notice to the banking entity that the [Agency] has determined that one or more of the banking entity's activities violates the prohibitions under" the proprietary trading restrictions.[61] In contrast, as noted, the rebuttal process in relation to banking entities with limited TAL (Proposal, Section __.20(g)(2)) contains a notice and response procedure prior to an Agency determination, and a final written determination that "will include an explanation of

[58] Preamble to Proposal at 222-3.

[59] For example, under the accounting prong's absolute P&L threshold presumption, exceeding the threshold "at any point" requires "prompt" notification to an Agency, and immediate "demonstrat[ion] that the trading desk's purchases and sales of financial instruments comply with" the proprietary trading restrictions.

[60] Proposal, § __.3(c)(2).

[61] Preamble to Proposal at 295.

the decision".[62] Commenters should consider the benefits in each situation of a pre-determination notice and response process.

- The intersection of the various rebuttal processes and the newly proposed "reservations of authority" also creates some questions.[63] Even if the Agencies were to amend the rebuttal processes to include explicit prior notice procedures and the contemplation of reasonable conformance periods, it would appear that the reservation of authority provisions could be used in a way similar to a rebuttal.[64] Indeed, in proposed Section __.20(h), the Proposal specifically states that the reservation of authority "to require a banking entity . . . to apply any requirement" may be applied "if the [Agency] determines that . . . [the banking entity] does not warrant a presumption of compliance . . ." These questions are compounded somewhat by the fact that the reservation of authority provisions are also drafted differently without explanation.[65] Commenters should consider whether the rebuttal processes and reservations of authority should be simplified and clarified—e.g., whether the rebuttal processes should be the sole means of rebutting the presumptions (once they include additional pre-determination and post-determination process), or whether the rebuttal procedures should be replaced by a simpler reservation of authority..
- Another question is whether the Agencies should include an appeal process, separate from the conformance or remediation period, after a determination is made by an Agency.
- Commenters may also wish to suggest that some or all of the presumptions be coupled with "safe harbors" for some elements or characteristics of the presumption, so as to create certain bright lines for avoiding a rebuttal.

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[62] Proposal, § __.20(g)(2)(ii)(C).

[63] See Proposal, §§ __.3(g), __.20(h).

[64] We separately note that the reservation of authority in Proposal § __.3(g) provides that an Agency "may determine, on a case-by-case basis, that a purchase or sale of one or more financial instruments . . . either is or is not for the trading account" (emphasis added). A determination by an Agency that a purchase or sale "is not" for the trading account is not subject to the notice and response procedures. Provided that examiners are empowered to use this provision and that decisions are rendered on a timely basis, this procedure could provide some modest relief from the wide scope of the proposed accounting prong.

[65] Compare Proposal, § __.3(g) (notice and response procedures described) with Proposal, § __.20(h) (no process described).

TABLE III.A. COMPARISON OF COMPLIANCE OBLIGATIONS: 2013 FINAL RULE VS. THE PROPOSAL[66]

OBLIGATION	APPLICABILITY UNDER 2013 FINAL RULE	APPLICABILITY UNDER PROPOSAL
Requirement to Maintain a Compliance Program	All banking entities engaged in covered proprietary trading or covered fund activities	Significant or moderate TAL
Six-Pillar Compliance Program	All banking entities, except those with no covered activities or with total consolidated assets of $10 billion or less	Significant TAL
CEO Attestation	Total consolidated assets of $50 billion or more, or TAL of $10 billion or more[67]	Significant or moderate TAL
Additional Documentation for Covered Funds	Total consolidated assets of $10 billion or more	Significant TAL
Simplified Compliance Program	Total consolidated assets of $10 billion or less	Moderate TAL
Metrics Reporting (Appendix A)	TAL of $10 billion or more[67]	Significant TAL (unchanged)
Enhanced Minimum Compliance Procedures (Appendix B)	Total consolidated assets of $50 billion or more, or TAL of $10 billion or more[67]	Eliminated (other than CEO attestation per above)
Presumption of Overall Compliance	N/A	Limited TAL
No Compliance Program Required	No covered activities	No covered activities
Statutory Exemption Under the 2018 Regulatory Relief Act	Total consolidated assets of $10 billion or less, and TAL of 5% or less of total consolidated assets, effective as of May 24, 2018[68]	

[66] Other than as described in the last row of the Table, Table III.A does not incorporate the effects of the 2018 Regulatory Relief Act.

[67] For FBOs, measured based on combined U.S. operations.

[68] The statute does not specify how these thresholds are measured for FBOs.

TABLE III.B. COMPARISON OF METRICS REPORTING: 2013 FINAL RULE VS. THE PROPOSAL

METRIC UNDER 2013 FINAL RULE	METRIC UNDER PROPOSAL	APPLICABILITY UNDER PROPOSAL[69]
Risk and Position Limits and Usage	Generally the same, but would eliminate the mandate to use Stressed VaR as a trading desk risk limit	Each trading desk engaged in covered trading activity
Risk Factor Sensitivities	Generally the same	Each trading desk engaged in covered trading activity
VaR and Stressed VaR	Generally the same, but clarifies that the metric is calculated to a 99% confidence level over a one-day period	Each trading desk engaged in covered trading activity, except that Stressed VaR would not be required from desks that exclusively hedge products—such as loans, certain commodities, and FX—that are excluded from the definition of "financial instrument" under the Volcker Rule
Comprehensive Profit and Loss Attribution	Generally the same	Each trading desk engaged in covered trading activity
Inventory Turnover	Replaced with "Positions" metric	Trading desks that rely on the underwriting or market-making exemptions
Customer-Facing Trade Volumes	Replaced with a broader "Transaction Volumes" metric	Trading desks that rely on the underwriting or market-making exemptions
Inventory Aging	Limited to only "Securities" Inventory Aging	Trading desks that rely on the underwriting or market-making exemption for securities activity

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[69] Under the 2013 Final Rule, banking entities must report each metric for each trading desk engaged in covered trading activity.