ALERT MEMORANDUM

Agencies Adopt Final Rule Implementing Key Elements of Volcker 2.0

Covered Funds Proposal Still to Come

August 28, 2019

On August 20, 2019, two of the agencies responsible for implementing the Volcker Rule finalized amendments to the Rule that narrow and simplify the proprietary trading prohibition and significantly reduce compliance burdens. The Final Rule includes only limited revisions to the covered fund provisions. The Agencies deferred to a forthcoming notice of proposed rulemaking all of the significant, more complicated covered fund issues that had been the subject of questions in the Agencies' 2018 proposal.

Accounting Prong and Proprietary Trading: The Final Rule adopted by the FDIC and the OCC resolves the issue of greatest concern to the banking industry by removing the new accounting prong that the Agencies proposed last year to replace the purpose test in the trading account definition.

- The Agencies had intended the accounting prong to provide a simpler, objective test to address industry concerns about the scope of the subjective purpose test and related 60-day rebuttable presumption. However, it quickly became apparent after the 2018 proposal that the accounting prong would expand the proprietary trading prohibition's scope to sweep in many positions not intended to be prohibited, including some long-term investments.
- Following months of comments and discussions about whether to modify the new prong or to drop it all together, and whether the Agencies would need to re-propose whatever alternative they chose, the Agencies adopted a simple and final solution by dropping the proposed prong, and placing increased reliance on the market-risk capital prong.
- The Final Rule also reverses the presumption in the short-term purpose prong so that instruments held for 60 days or longer are presumed not covered. With these and other amendments, the Final Rule provides a simpler proprietary trading prohibition that appears better tailored to the activities that the statute intended to address.

Compliance Program: Consistent with other recent efforts by the Agencies and Congress to reduce compliance burdens, the Final Rule also narrows the application of the rule's most significant compliance program requirements, including the CEO attestation, to institutions with the largest trading operations.

- The Final Rule went further than last year's proposal, increasing the threshold for metrics reporting and several other requirements from $10 billion to $20 billion in trading assets and liabilities and the threshold for the CEO attestation from $1 billion in the proposal to $20 billion.

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- Although institutions previously subject to these requirements have already incurred the expense of building compliance and reporting structures, relief from these requirements going forward, particularly from the CEO attestation, will significantly reduce ongoing burdens.

Foreign Banking Organizations: The Final Rule included two changes of particular importance for foreign banking organizations.

- It revised the exemption for foreign banks' trading outside the United States to remove the restriction on trading with or through U.S. counterparties and the prohibition on using U.S. personnel to arrange, negotiate or execute a transaction. This finally resolves one of most significant objections of foreign banks to the extraterritorial scope of original 2013 rule.
- The Final Rule also resolves a provision of the 2018 proposal that would have extended the CEO attestation and other requirements to many foreign banks with limited U.S. operations.

Covered Funds: The Agencies finalized all of the revisions they specifically proposed last year, including the addition of an exemption permitting acquisition of covered fund interests to hedge transactions facilitating a customer's exposure to a covered fund, and excluding from the aggregate and per-fund limits and the Volcker Rule capital deduction interests in third-party covered funds acquired under the market-making or underwriting exemptions.

- However, by declining to include in the Final Rule any revisions on the many topics that were the subject of extensive questions but not proposed text in the 2018 proposal, the Agencies have put the most significant covered funds issues on a significantly longer timetable. This decision was likely driven by a combination of concern about delaying finalization of the proprietary trading and compliance revisions, and the potential for criticism if the Agencies had adopted revisions in a final rule without the opportunity to comment on a specific proposal.
- The significant issues that remain to be addressed include the scope of the covered funds definition (*e.g.*, whether to move to a "characteristics-based" definition and whether venture capital funds and family wealth management vehicles should be covered), the scope of exclusions for foreign public funds and joint ventures, the treatment of certain controlled investment vehicles as "banking entities", and incorporation of Regulation W exclusions into the so-called "Super 23A" prohibition.

Effective Date: The effective date of the Final Rule is January 1, 2020, with compliance required by January 1, 2021. Banking entities may elect to apply any rule change sooner, in whole or in part. In the case of metrics reporting, early application is subject to the Agencies adopting certain required technological updates. This ability to opt into the Final Rule early appears to include the revised scope of CEO attestations. This should mean that institutions no longer subject to the CEO attestation requirement should not be required to submit them in March 2020. However, this was not explicitly addressed.

A detailed summary and analysis of the Final Rule follows below, expanding on the key takeaways we summarized in our highlights Alert Memo of August 20, 2019.

Three-Tiered Compliance Framework

The Final Rule[1] establishes a new three-tiered compliance regime based on a banking organization's gross trading assets and trading liabilities ("TAL"), with the most intensive compliance requirements applicable only to institutions with the largest trading activities, and those with minimal trading activities benefitting from a presumption of compliance. The requirements applicable to banking entities within these three tiers are outlined in Table I.A at the end of this Memorandum. While the three-tiered construct was generally adopted as proposed,[2] there are notable modifications pertaining to:

— the threshold for significant TAL institutions,

— the applicability of the CEO attestation requirement and

— the TAL calculation methodology for foreign banking organizations ("FBOs").

Structure of Three-Tiered Compliance Regime

The compliance requirements have has been tailored to the size of a banking entity's TAL:

— *Significant TAL: TAL of $20 Billion or More*

In a change from the Proposal, the threshold for significant TAL institutions was raised from $10 billion to $20 billion. The Agencies noted that the higher threshold would give certainty to banking entities that approach the original $10 billion threshold and may cross it (even temporarily) due to market events or unusual customer demands. According to the Agencies, an estimated 93% of TAL held in the U.S. banking system are held by significant TAL institutions; adding moderate TAL institutions to this estimate raises this statistic to 99%.

Banking entities with significant TAL are subject to the most robust compliance requirements, including:

- The "six-pillar" compliance program: the more granular and prescriptive "enhanced compliance program" in Appendix B of the 2013 Rule was removed in favor of the flexibility afforded by these six general compliance program requirements:
  - written policies and procedures,
  - internal controls to monitor compliance,
  - a management framework that delineates responsibility and accountability,
  - independent testing and audit of the compliance program,
  - training and
  - recordkeeping.
- the metrics reporting requirements, as reduced and modified by the Final Rule,
- the covered fund documentation requirements,
- the exemption-specific and more prescriptive compliance program requirements of the market making and underwriting exemptions, and
- the CEO attestation requirement.

— *Moderate TAL: TAL from $1 Billion to $20 Billion*

Banking entities with moderate TAL will be subject only to a simplified compliance program requirement (previously available only to banking entities with $10 billion or less in total consolidated assets).

As a result, these banking entities will not be required to implement the specific six-pillar compliance program, but can instead satisfy the compliance program requirement by including in

[1] "Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds" (Aug. 20, 2019), https://www.fdic.gov/news/board/2019/2019-08-20-notice-dis-a-fr.pdf (the "Final Rule").

[2] "Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds", 83 Fed. Reg. 33,432 (July 17, 2018) (the "Proposal").

existing compliance policies and procedures references to the Volcker Rule requirements as appropriate given the activities, size, scope and complexity of the organization.

Key relief for moderate TAL entities comes primarily from:

- no longer being subject to the CEO attestation requirement (in contrast to the Proposal, which would have applied the attestation requirement to both significant and moderate TAL entities) and
- certain moderate TAL entities (primarily those with TAL between $10 billion and $20 billion) no longer being required to report metrics for trading desks.

— *Limited TAL: TAL of Less than $1 Billion*

Consistent with the Proposal, banking entities with limited TAL will benefit from a new rebuttable presumption of compliance. These institutions are no longer subject to a compliance program requirement, and as explained in the Proposal, "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".

Agency Authority in Relation to Banking Entity Placement Within the Tiers

The Final Rule reserved authority for the Agencies to determine that any of the requirements applicable only to a significant TAL banking entity could be applied to a moderate or limited TAL entity. In addition, the rebuttable presumption of compliance for limited TAL entities can be rebutted by an Agency if the Agency "determines that the banking entity has engaged in proprietary trading or covered fund activities that are otherwise prohibited" under the Volcker Rule.

In either case, the Agencies would follow written notice procedures, allowing response from the banking entity and requiring a subsequent written determination and explanation from the Agency (the "notice and response procedures").

Calculation of TAL

TAL is calculated as the average gross sum of TAL over the previous consecutive four quarters, as measured on the last day of each quarter.

— The calculation excludes TAL attributable to trading in obligations of or guaranteed by the United States (or any agency of the United States).

— The Agencies encouraged banking entities to rely on line items from existing regulatory reporting forms to the extent possible to calculate TAL. Nevertheless, there will be certain entities (*e.g.*, FBOs without an intermediate holding company) that may have to incorporate information from other reports or balance sheets. These banking entities should look to the reporting form definitions of trading assets and liabilities to make judgments on data that should be included in the calculation.

For FBOs, the TAL calculation for all thresholds will be based on their combined U.S. operations only. While the proposed threshold for significant TAL was based on U.S. operations, the calculation dividing moderate TAL and limited TAL in the Proposal was based on global TAL.

— This change, coupled with the elimination of the CEO attestation requirement for moderate TAL banking entities, reverses what would have been a significant expansion of the CEO attestation requirement under the Proposal to many FBOs with limited U.S. operations.

— Commenters noted that the proposed tying of certain requirements to global TAL risked imposing undue burdens on FBOs with little U.S. trading activity. In explaining the reasoning behind changing the limited TAL calculation, the Agencies note the lower risk to the U.S. financial system of FBO trading activities booked outside the U.S. as well as the Volcker Rule's general accommodations for FBOs' non-U.S. activities (however, an FBO will need to include in its combined U.S. operations calculation TAL of non-U.S. branches and agencies

that are managed or controlled by a U.S. branch or agency of the FBO).

Proprietary Trading

Trading Account Definition

The Final Rule includes several important modifications to the "trading account" definition, with a stated goal of encouraging simplicity and flexibility and tailoring of the scope of restricted proprietary trading activities.

— *Proposed Accounting Prong*

The Proposal would have replaced the short-term purpose prong of the trading account definition 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 Proposal also would have presumed compliance by a trading desk subject only to the accounting prong if the desk did not exceed a quantitative limit of $25 million of absolute profit and loss ("absolute P&L") calculated daily on a 90-day look-back basis.

As anticipated, the Agencies did not adopt the accounting prong, and agreed with commenters' concerns that the accounting prong would have inappropriately scoped in (1) many financial instruments and activities that the Volcker Rule was not intended to capture, including longer-term investments, (2) instruments regardless of the banking entity's purpose for buying or selling (*e.g.*, all derivatives and equity securities with a readily determinable fair value) and (3) seeding activity that would otherwise be permitted under the Volcker Rule's covered funds provisions. The Agencies also did not adopt the trading desk-level presumption of compliance tied to absolute P&L.

— *Short-Term Purpose Prong*

The Agencies have retained the short-term purpose prong, which the Proposal would have eliminated, and have made two key modifications.

- First, the Agencies reversed the rebuttable presumption for financial instruments held for fewer than 60 days such that instruments held for 60 days or longer are not within the short-term purpose prong.

  The Agencies cited several activities that they believe should not be included in the definition of proprietary trading, but that they found were often captured by the 60-day rebuttable presumption, including asset-liability management activities, certain liquidity management activities, transactions to correct error trades, loan-related swaps and certain matched derivative transactions.

  While the Agencies did not create a broad exemption for asset-liability management activities, as requested by some commenters, there are several aspects of the Final Rule that could support a determination that many asset-liability management activities could be deemed outside the trading account, including mentioning asset-liability management activities as among those captured by the 2013 Rule's 60-day rebuttable presumption but that "should not be included in the definition of proprietary trading".[3]

  The Agencies also expect that the reversal of the presumption will provide relief for foreign branches of U.S. banking entities that must purchase short-term foreign sovereign debt obligations to meet host-country regulatory requirements, thus also recognizing that the original 60-day rebuttable presumption

[3] These aspects include: (1) the ability to make trading account determinations based solely on the market risk capital rule distinction between "trading book" and "banking book", (2) the Agencies' molding of the short-term purpose prong to be more congruent with the market risk capital prong, including through the exclusion of any transaction not meeting the definition of "trading asset" or "trading liability" in relevant reporting forms, and (3) the receptivity of the Agencies, through statements in the preamble, to the concept of determining that assets may not be "for the trading account". *See*, *e.g.*, Financial Stability Oversight Council, Study & Recommendations (2011) at 47.

inappropriately captured instruments with a short maturity (or a short time remaining until maturity) regardless of intent of the banking entity.

- Second, the Final Rule narrows the scope of banking entities that are subject to the short-term purpose prong to those that are not subject to the market risk capital rule. The Agencies adopted this change to eliminate redundancy, in response to comments that the scope of activities captured by the short-term purpose prong and the market risk capital prong is substantially similar.

  Several of the new exclusions from proprietary trading described below (*i.e.*, exclusions for hedges to mortgage servicing rights and for instruments that are not trading assets or trading liabilities as defined in relevant reporting forms) are designed to provide parity between smaller institutions that rely on the short-term purpose prong and larger institutions that rely on the market risk capital prong. These now-excluded instruments are not covered by the market risk capital rule, but potentially could have been covered by the short-term purpose prong, and this disparity could have provided an advantage for larger banking entities.

— *Market Risk Capital Prong*

Under the Final Rule, institutions subject to the U.S. market risk capital rule must look only to the market risk capital prong and the dealer prong, and may not apply the short-term purpose prong. Other banking entities (which may include entities controlled but not consolidated with a market risk capital parent) will be subject to the short-term purpose prong, but:

- these entities may elect to apply the definitions of the market risk capital prong instead, provided the election is made with regard to a banking entity and all of its wholly-owned subsidiaries, or
- an Agency may subject a banking entity that is not a wholly owned subsidiary to the market risk capital prong if the Agency determines that doing so is necessary to prevent evasion, after following the notice and response procedures.

The opt-in approach is designed to provide parity between smaller banking entities that are not subject to the market risk capital rule and larger banking entities with active trading businesses that are subject to the market risk capital rule.

The Agencies declined to adopt a proposed modification that would have captured trading positions of FBOs that are subject to home-country market risk capital requirements consistent with the Basel Committee's market risk framework. Instead, the Agencies expect that FBOs may either rely on the short-term purpose prong or elect to apply the market risk capital prong, if reliance on the short-term purpose prong would create a disadvantage relative to U.S. competitors. Nevertheless, a banking entity is required to apply the definitions under the U.S. market risk capital rule if any affiliate with which the banking entity is consolidated for regulatory reporting purposes applies the market risk capital rule. Since the scope of this requirement is not further clarified, FBOs may seek to clarify with the Federal Reserve whether the requirement to apply the U.S. market risk capital rule definitions was intended to also apply to the development of compliance programs for trading desks outside the U.S. that are subject to the Volcker Rule. .

By not requiring that banking entities apply both the market risk capital prong and the short-term purpose prong, the Agencies have removed a significant source of ambiguity and "scope creep" arising out of the need to review separately any non-market risk capital positions under the subjective purpose prong and its accompanying 60-day rebuttable presumption.

— *Dealer Prong*

The Agencies did not make any modifications to this prong, but reaffirmed at the request of commenters that it covers only those positions that require a banking entity to be licensed or registered as a dealer.

— *Reservation of Authority*

The Final Rule declined to adopt a proposed reservation authority for a banking entity's primary regulatory Agency to determine on a case-by-case basis whether the banking entity engaged in a purchase or sale of a financial instrument as principal for the trading account (subject to an opportunity for the banking entity to submit a response challenging the determination). The Agencies noted that this reservation of authority is unnecessary because the short-term purpose prong has been retained.

Trading Desk Definition

The Final Rule creates a multi-factor "trading desk" definition to replace the 2013 Rule's definition of "trading desk" as the "smallest discrete unit" of organization that purchases or sells financial instruments for the trading account of a banking entity or an affiliate. The new definition is designed to align with criteria used to establish trading desks for other operational, management and compliance purposes. For all banking entities, these criteria include a clearly defined unit that engages in coordinated trading activity, operates subject to a common set of risk levels and limits, submits information to management as a unit and books its trades together. For banking entities that rely on the market risk capital prong, a trading desk means a unit of organization established for purposes of capital requirements under the market risk capital rule.

The Agencies are likely to implement a similar definition when they finalize rules related to the Fundamental Review of the Trading Book, demonstrating a focus throughout the Final Rule on harmonizing definitions between the Volcker Rule and other Agency rules.

Exclusions

The Agencies adopted several new or expanded exclusions from the "proprietary trading" definition.

— *Liquidity Management Exclusion*

The Final Rule expands the instruments that may fall within the liquidity management exclusion beyond securities to include foreign exchange forwards, foreign exchange swaps and cross-currency swaps (expanded since the Proposal to include non-deliverable cross currency swaps).

However, for each instrument, the Agencies were adamant that the other requirements of the liquidity management exclusion must be met, and they declined to eliminate or curtail some of the parameters of the required liquidity management plan. The Agencies also rejected comments to expand the exclusion to other types of financial instruments used in asset-liability management or treasury functions. The expansion of the list of products that now may qualify for the exclusion is an acknowledgement that cross-border liquidity management is prevalent among banking entities subject to the Volcker Rule and that the original liquidity management exclusion may have addressed stores of liquidity (securities) without truly addressing "liquidity management".

— *Error Trades Exclusion*

The Agencies finalized substantially as proposed the exclusion for transactions made in error and subsequent transactions to correct the error. Even though the less-than-60-day rebuttable presumption also was removed, the Agencies noted explicitly that banking entities do not enter into error trades and correcting transactions principally for the purpose of selling in the near-term or otherwise with the intent to profit from short-term price movements.

The Agencies did not adopt a proposed requirement to transfer the error trade to a separately managed error account in response to comments that this requirement could have resulted in duplicative resolution systems and undue costs. The Agencies also declined to include additional Volcker Rule-specific audit or monitoring requirements in respect of this exclusion. However, the Agencies noted that they expect this exclusion to be used infrequently because a high magnitude and frequency of errors may suggest evasion.

— *Matched Derivative Transactions Exclusion*

While many commenters had requested an exclusion or clarification related to derivatives entered into in a "riskless principal" capacity, the Agencies adopted a limited exclusion for certain matched/backed-to-back derivatives if:

- one derivative is "customer-driven",
- the customer-driven derivative is "contemporaneously" matched or backed-to-back with another party, on an individual (not portfolio) basis,
- the banking entity conducting the trades is not a registered swap or security-based swap dealer under U.S. rules, and
- the banking entity retains no more than minimal price risk.

This exclusion is intended to pick up the proposed exclusion for loan-related swaps, as the Agencies believed that many smaller banking entities engage in loan-related swaps on a matched basis. However, the Agencies acknowledged that the exclusion would apply to a broader array of swaps with customers. The Agencies believe this exclusion will avoid disrupting common and traditional banking services provided to small and medium-sized businesses.

The exclusion only applies to entities not registered as a U.S. swap dealer or security-based swap dealer, and thus dealer banks will have to rely on the greater flexibility afforded by changes to the market making exemption (rather than this exclusion from the "proprietary trading" definition). It appears that entities that may be dealers outside the United States, but not registered as swap or security-based swap dealers under U.S. rules, could benefit from this exclusion.

The Agencies were clear that a transaction could fail to meet one or more of the exclusion criteria, but (based on other factors) not constitute "trading account" activity. In particular, the Agencies suggested that, depending upon circumstances, unmatched loan-related swaps (*i.e.*, where a back-to-back hedge or other transaction is not entered) "are unlikely to be within the trading account" under the Final Rule.

This exclusion should be analyzed together with certain Agency statements (described below) in relation to inter-affiliate and inter-desk transactions to determine additional benefits and flexibility that may be afforded to "hub-and-spoke" risk management, where non-dealing, but customer-facing, business units back-to-back transactions to a centralized market making desk that manages the risks on a portfolio basis.

— *Exclusions to Align the Short-Term Purpose Prong with the Market Risk Capital Prong*

- *Hedges of Mortgage Servicing Rights or Assets.* The Final Rule excludes any financial instrument used to hedge mortgage servicing rights or assets. Although banking entities no longer need to rely on the risk-mitigating hedging exemption for this activity, the Agencies nonetheless adopted this exclusion only with respect to bona fide hedging activities conducted in accordance with a documented strategy.
- *Instruments That Are Not Trading Assets or Liabilities.* The Agencies excluded any financial instrument that does not meet the definition of "trading asset" or "trading liability" under an applicable regulatory reporting form (determined as of January 1, 2020, the effective date of the rule).[4]

[4] *See, e.g.,* Instructions for Preparation of Consolidated Financial Statements for Holding Companies (Form FR Y-9C) at HC-7 (Effective June 2018) ("Trading activities typically include (a) regularly underwriting or dealing in securities; interest rate, foreign exchange rate, commodity, equity, and credit derivative contracts; other financial instruments; and other assets for resale; (b) acquiring or taking positions in such items principally for the purpose of selling in the near term or otherwise with the intent to resell in order to profit from short-term price movements; or

Underwriting and Market Making

— *Presumption of Compliance*

The Agencies finalized largely as proposed a presumption that a trading desk operating within internally-set risk and other limits satisfies the reasonably expected near-term demand ("RENTD") requirement, which requires that permitted underwriting and market-making activities not exceed the RENTD of clients, customers and counterparties. Banking entities would be permitted to base risk and other desk limits on internal models and analyses rather than any mandatory analysis.

Internal limits, however, are required 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. Therefore, the Final Rule does not eliminate RENTD as a requirement or a parameter, but the key innovation is in the presumption of compliance, which is expected to alleviate transaction- and inventory-level review in favor of more general supervisory monitoring of the desk's risk management.

At a minimum:

- internal limits for underwriting desks need to be set 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; and
- internal limits for market making desks need to be set 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.

The Agencies have clarified in the Final Rule that such limits need not take into account "a demonstrable analysis of historical customer demand", but should take into account the "liquidity, maturity, and depth" of the market for the relevant types of financial instruments. The Agencies indicated that this allows for the internal limits for one type of instrument to not necessarily be the same as for other types. Internal risk limits remain subject to Agency oversight and supervisory review on an ongoing basis.

An Agency can rebut the presumption of compliance using the notice and response procedures, based on a determination that a trading desk is engaging in activity not based on RENTD and taking into account the liquidity, maturity, and depth of the market for the relevant types of financial instruments and all relevant facts and circumstances.

The Final Rule includes helpful preamble language noting that banking entities have flexibility to determine appropriate limits for market making-related activities that are designed not to exceed RENTD. For example, an internal limit on an "amount" or "time of holding" may be more readily applied to desks that engage in market-making in securities, rather than derivatives. In this context, the Agencies clarified that a derivatives desk may establish limits based on the desk's level of exposures to relevant risk factors and not necessarily based significantly on the other three factors.

— *Risk Limit Breaches*

In contrast to the Proposal, banking entities will not be required to promptly report limit breaches and increases, provided that banking entities maintain records that are available to the Agencies upon request. The Agencies clarified that the

(c) acquiring or taking positions in such items as an accommodation to customers or for other trading purposes.").

presumption will continue to be available when a limit is breached or increased, so long as a banking entity takes prompt action to come into compliance consistent with written procedures.

— *Compliance Program*

Banking entities with moderate or limited TAL are no longer subject to exemption-specific compliance program elements for underwriting and market-making, in recognition of the fact that these banking entities comprise a small percentage of the total U.S. trading activity subject to the Volcker Rule. Banking entities with significant TAL will remain subject to specific written compliance program requirements for permitted underwriting and market making-related activities.

— *Inter-Desk Transactions*

In the preamble, the Final Rule provides some insights into inter-desk and inter-affiliate transactions:

- "Each trading desk engaging in a transaction with an affiliated trading desk that meets the definition of proprietary trading must rely on an exemption or exclusion in order for the transaction to be permissible."
- But, "transactions between one trading desk and another trading desk in which the second desk books the position in the same banking entity as the first are not purchases or sales of financial instruments subject to the rule, including the prohibition on proprietary trading".
- Nevertheless, the Agencies declined to permit banking entities to treat affiliated trading desks as "clients, customers or counterparties", stating that "each trading desk must be able to independently tie its activities to the RENTD of external customers that the trading desk services".

For the most part, the industry tends to view inter-desk/inter-affiliate transactions as resulting in risk transfer to or from a desk that is required to be captured within the desk's risk and Volcker limits and compliance programs. Nevertheless, the statement regarding intra-entity transactions, coupled with the matched derivative exclusion, is likely to provide some added flexibility to banking entities that had determined (or were urged by one or more of the Agencies to determine) that certain desks that did not manage risk, but backed-to-back that risk to market making desks in a hub-and-spoke model, should still be relying on the market making or risk-mitigating hedging exemptions.

Risk-Mitigating Hedging

— *Streamlining*

The Agencies eliminated two requirements of the 2013 Rule's risk-mitigating hedging exemption:

- First, banking entities no longer must conduct a correlation analysis. The Agencies determined this was not mandated by the statute and that banking entities should have flexibility to apply analysis that is appropriate to assess particular hedging activity.
- Second, banking entities no longer must show that a hedge "demonstrably" reduces or otherwise significantly mitigates an identifiable risk. A banking entity must still "design" or "reasonably expect" its hedging activity to reduce or significantly mitigate one or more risks.

— *Compliance*

The Agencies finalized as proposed the elimination of specific compliance program and documentation requirements for banking entities that have moderate or limited TAL, consistent with changes to the compliance program requirements for the underwriting and market-making exemptions.

Banking entities with significant TAL would remain subject to a requirement to maintain exemption-specific programs. Enhanced documentation requirements for hedging across business units would remain applicable to significant TAL entities, except in relation to hedging activity undertaken pursuant to certain

pre-approved lists of commonly used financial instruments and hedging limits.

Permitted Trading for FBOs

The Agencies eliminated several conditions to the exemption for FBOs' trading outside the United States ("TOTUS Exemption"):

— the restriction on conducting transactions with or through a U.S. entity,

— the prohibition on financing of a TOTUS transaction by an FBO's U.S. branch or affiliate, and

— the requirement that any FBO personnel who "arrange, negotiate or execute" a TOTUS transaction be located outside the United States.

However, the Agencies retained the restrictions that require:

— the transacting/booking entity to be outside the U.S. and to not be organized in or a subsidiary of an entity organized in the U.S.,

— the decision-making entity and relevant personnel to be outside the U.S. (likely requiring that execution also be outside the U.S.), and

— the instrument or any hedging instrument to not be accounted for as principal by a U.S. branch or affiliate.

The proposed changes to the TOTUS Exemption's requirements are 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 U.S. Bank Holding Company Act. The Federal Reserve has traditionally taken a territorial approach to regulation, generally imposing most requirements on FBOs to their activities conducted and booked in the United States through branches, agencies and subsidiaries. The Agencies note that the revised exemption focuses on the location of an FBO's decision to trade, actions as principal, and principal risk of the transaction.

Metrics Reporting for Trading Provisions

The Final Rule applies metrics reporting only to those banking entities with significant TAL, thus relieving banking entities with between $10 billion and $20 billion of TAL from the requirement.

In addition, the Final Rule revises and simplifies the quantitative metrics reporting requirements relative to both the 2013 Rule and the Proposal. We describe these changes in more detail in Table I.B below. Agency estimates suggest that, as a result of these changes, the number of data items will be reduced by 67 percent and the total volume of data will be reduced by 94 percent as compared to the 2013 Rule's metrics reporting requirements.

— *Changes to the Quantitative Metrics*

- Retained metrics: Internal Limits and Usage; Value-at-Risk; Comprehensive P&L Attribution.
- Eliminated metrics: Risk Factor Sensitivities; Stressed VaR; Inventory Turnover; Inventory Aging and Customer-Facing Trade Ratio.
- Added metrics (but only for market making and underwriting desks): Positions; Transaction Volumes.

— *Changes to Narrative Reporting Requirements*

The Proposal created certain new narrative reporting requirements, and the Final Rule adopted a subset of these with modifications.

- *Trading Desk Information*

Institutions must provide descriptive information about each trading desk, its trading strategy and the type of covered activity in which the trading desk is engaged. However, the Final Rule removes the Proposal's requirement to identify the financial instruments that the trading desk trades.

The Final Rule also eliminates the Proposal's requirement for each trading desk to "identify the legal entities that serve as booking entities for each trading desk." In its place, the Final

Rule simply requires institutions to identify "each agency receiving the submission of the desk".

- *Reporting Metrics Information*

  As proposed, the Final Rule requires descriptive information about reporting metrics, in particular information schedules providing descriptions of risk and position limits reported on the Internal Limits Information Schedule and risk factor attributions reported under the Comprehensive Profit and Loss Attribution metric.

  Because the Final Rule removes the metrics for Risk Factor Sensitivities, it also has removed the Proposal's requirement for a Risk Factor Sensitivities Information Schedule, as well as a requirement for banking entities to provide separate cross-reference schedules describing relationships between the risk factor sensitivities and (i) risk and position limits and (ii) risk factor attributions. These changes reduced the additional proposed schedules from five to two.

- *Narrative Statement*

  The Agencies declined to adopt the Proposal's requirement that a banking entity provide 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) in favor of an option for a voluntary statement. The Agencies note that the compliance costs of requiring the statement outweigh the benefits to the Agencies, although they anticipate that banking entities will continue to voluntarily provide similar information.

— *Timeframe and Logistics for Metrics Reporting*

The Final Rule:

- changes the frequency of filing to quarterly for all reporters, including those with $50 billion or more TAL that had been filing monthly under the 2013 Rule,
- extends the timeframe for reporting to 30 days after the end of the quarter for all reporters, including those with $50 billion or more TAL that had been filing within 10 days of the end of each month, and
- requires all banking entities to use a standardized reporting format, based on XML schema to be provided by each Agency.

Covered Funds

The Final Rule adopted without change all of the specific proposed revisions to the covered funds provisions that were included in the Proposal. These include broadening the exemption for risk-mitigating hedging, excluding covered fund interests acquired in a market-making or underwriting capacity from applicable 3% limits and the covered fund capital deduction, and revisions to the exemption for FBOs' funds activities outside the United States ("SOTUS Exemption").

However, the Final Rule does not include any changes to the covered funds provisions other than those that were specifically proposed last year. This defers the bulk of the most significant issues related to covered funds to a forthcoming notice of proposed rulemaking. Issues still be addressed include the scope of the definition of covered funds, certain banking entity issues related to controlled vehicles (such as registered investment vehicles, foreign excluded funds, and employee securities companies), the exclusion for foreign public funds, and revisions to the Super 23A prohibition on certain transactions with related covered funds.

Underwriting and Market Making

— *The 3% Aggregate and Per-Fund Limits and Capital Deduction Requirements*

The Final Rule eliminates the application of the 3% aggregate and per-fund limits and the capital deduction to ownership interests in third-party covered funds acquired by a banking entity in reliance on the underwriting or market-making exemptions.

The Final Rule also eliminates application 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 funds.

The Agencies declined to extend the same relief to positions held in an institution's own funds, which the Agencies had raised as a question in the Proposal but not included in their proposed text. Consistent with their approach on other covered fund provisions where they adopted only exactly what was proposed, the Agencies indicated that this potential adjustment to the proposed language would be considered in connection with the forthcoming proposal. Thus, pending any further changes, the Final Rule provides that the 3% aggregate (and per-fund) limits and capital deduction requirement continue to apply to underwriting or market-making positions in covered funds for which a banking entity (i) acts as sponsor; (ii) acts as investment adviser or commodity trading advisor; (iii) relies on the asset management exemption to acquire or retain an ownership interest or (iv) relies on the securitization exemption (whether as securitizer or risk retainer) to acquire or retain an ownership interest.

This change provides significant relief from compliance burdens associated with trying to determine whether interests permissibly acquired in the context of trading in third-party funds are covered fund interests. Under the 2013 Rule, while the acquisition of such interests was permissible in reliance on the underwriting or market-making exemptions, it was still necessary to determine whether or not they were covered fund interests in order to accurately calculate the 3% aggregate limit and the capital deduction. Market participants engaged in large-scale compliance projects, individually and collectively, to attempt to address this challenge, but it continued to create uncertainty and impose significant compliance costs. In declining to extend the relief beyond third-party funds at this time, the Agencies noted that a banking entity can more readily determine whether an issuer is a covered fund where the banking entity has organized and offered the fund.

— *Covered Fund Documentation Requirements*

The Final Rule retains the detailed covered fund documentation requirements in Section __.20(e) for banking entities with significant TAL. While those generally apply to covered funds sponsored or seeded by a banking entity, U.S. banking entities are also required to calculate interests held in foreign public funds if such interests exceed $50 million in aggregate. Given the challenges of differentiating between a foreign public fund and a covered fund in the market-making context, commenters on the forthcoming proposal may wish to argue for this requirement to be revised to exclude underwriting or market-making positions so that the recordkeeping requirement does not undermine the relief provided in the Final Rule by effectively continuing to require significant TAL institutions to track and count such positions.

Risk-Mitigating Hedging

The Final Rule adopts the proposed exemption to permit a banking entity to hold a covered fund interest as a risk-mitigating hedge when acting as an intermediary on behalf of a customer (that is not itself a banking entity) to facilitate the customer's exposure to the fund.

This change removes a significant impediment for fund-linked product businesses that were negatively impacted by the surprisingly restrictive approach the 2013 Rule took to hedging positions. The 2013 Rule had not only removed the exemption for hedging of customer-facilitation transactions that had been included in the 2011 proposal; the preamble to the 2013 Rule also made references to such hedging transactions potentially representing a "high-risk trading strategy" (which might then be impermissible under the backstop provisions in Section __.15(a)(2)). In the preamble to the Final Rule, the Agencies effectively disavow that view, noting that such customer facilitation and related hedging activities do not necessarily constitute a high-risk trading strategy.

The Final Rule retains the existing exemption's authority to hedge certain employee compensation arrangements, expanding it so that the current exemption's requirements will extend to the customer facilitation activities described above. Consistent with the changes to the proprietary trading hedging exemption, the Final Rule removes the requirement in the 2013 Rule that the risk-mitigating hedge "demonstrably reduce[] or otherwise significantly mitigate[]" identifiable risks. The hedge must still be designed to reduce or otherwise significantly mitigate specific, identifiable risks.

SOTUS Exemption for Non-U.S. Funds Activities

— *Financing Restriction*

Consistent with the Proposal, the Final Rule removes from the SOTUS Exemption the restriction prohibiting an FBO from relying on the exemption if the purchase or sale of ownership interests in covered funds is financed by a U.S. branch or agency of the FBO. This restriction was also eliminated in the TOTUS Exemption.

— *FBO Investments in Third-Party Funds*

The Agencies also incorporated into the Final Rule the interpretation of the SOTUS Exemption's U.S. marketing restriction that was set out in FAQ #13 in 2015. That FAQ interpreted Section __.13(b)(3) of the 2013 Rule, which provides that an ownership interest in a covered fund is not offered for sale or sold to a resident of the United States for purposes of the marketing restriction if it is sold or has been sold pursuant to an offering that does not target residents of the United States. Under FAQ #13 and the Final Rule, this limitation will not prevent an FBO from investing in third-party funds with U.S. investors as long as the FBO itself does not participate in an offering of the fund to U.S. persons (including serving as sponsor or investment adviser to the fund if it is offered to U.S. persons). This clarification resolved one of the most significant issues for FBOs, mitigating potentially severe impacts on their funds activities outside the United States.

Limitations on Relationships with Covered Funds

The Final Rule includes only one change to the so-called Super 23A provisions, a revision included in the Proposal 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.

Other Super 23A issues are expected to be addressed in the forthcoming proposal on covered funds.

Effective Date and Compliance Date

The effective date for the Final Rule is January 1, 2020, and the compliance date is January 1, 2021. Banking entities generally may choose to comply with the Final Rule before the compliance date, in whole or in part.

— However, with regard to the revised metrics reporting requirements, the Agencies indicated that:

- the Agencies themselves first need to adopt certain technological changes in order to accept the new metrics filings,
- the Agencies will publish on their websites the new XML format for submission,
- banking entities must do a successful test submission in the new XML format, and
- "banking entities should work with each appropriate [A]gency to determine how and when to voluntarily comply with the metrics requirements under the final rules and to notify such [A]gencies of their intent to comply, prior to the January 1, 2021, compliance date."

— Banking entities that are no longer subject to the CEO attestation requirement should not need to submit an attestation on March 31, 2020 if they choose to comply early with this aspect of the Final Rule, but this was not explicitly addressed.

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TABLE I.A. COMPARISON OF COMPLIANCE OBLIGATIONS: 2013 RULE, PROPOSAL AND FINAL RULE

Background to Table I.A.:

- *Significant TAL Threshold:* The Agencies modified the threshold for "significant" TAL institutions by raising it from $10 billion under the Proposal to $20 billion under the Final Rule.
- *FBO Calculation Methodology:* The Agencies modified the thresholds for "limited" TAL and "moderate" TAL for FBOs from calculation on a global basis under the Proposal to calculation based on combined U.S. operations under the Final Rule.
- *2018 Regulatory Relief Act Exemption for "Community Banks":* The Agencies adopted implementing regulations on July 9, 2019 exempting insured depository institutions ("IDIs") and every entity that controls the IDI from the Volcker Rule if (i) the IDI and every entity that controls the IDI has total consolidated assets of $10 billion or less and TAL of 5% or less of total consolidated assets, and (ii) the IDI and its affiliates are not affiliated either with an FBO that has a U.S. branch or agency or with an IDI that does not qualify for the exemption.

OBLIGATION	APPLICABILITY UNDER 2013 RULE	APPLICABILITY UNDER PROPOSAL	APPLICABILITY UNDER FINAL RULE
Requirement to Maintain a Compliance Program	All banking entities engaged in covered proprietary trading or covered fund activities	Significant or moderate TAL	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	Significant TAL
Simplified Compliance Program	Total consolidated assets of $10 billion or less	Moderate TAL	Moderate TAL
Presumption of Overall Compliance	N/A	Limited TAL	Limited TAL
CEO Attestation	Total consolidated assets of $50 billion or more, or TAL of $10 billion or more	Significant or moderate TAL	Significant TAL
Additional Documentation for Covered Funds	Total consolidated assets of $10 billion or more	Significant TAL	Significant TAL

OBLIGATION	APPLICABILITY UNDER 2013 RULE	APPLICABILITY UNDER PROPOSAL	APPLICABILITY UNDER FINAL RULE
Metrics Reporting (Appendix A)	TAL of $10 billion or more	Significant TAL	Significant TAL
Enhanced Minimum Compliance Procedures (Appendix B)	Total consolidated assets of $50 billion or more, or TAL of $10 billion or more	Eliminated (other than CEO attestation per above)	Eliminated (other than CEO attestation per above)

TABLE I.B. COMPARISON OF CHANGES TO QUANTITATIVE[5] METRICS REPORTING STANDARDS: 2013 RULE, PROPOSAL, FINAL RULE

METRIC UNDER 2013 RULE[6]		METRIC UNDER PROPOSAL	METRIC UNDER FINAL RULE
Risk and Position Limits and Usage	Metric	Generally the same, but would eliminate the mandate to use Stressed VaR as a trading desk risk limit	Generally adopted as proposed, including the elimination of Stressed VaR, but metric is now "Internal Limits and Usage." Additional "Internal Limits Information Schedule" is required, providing descriptive information about the limits used, although only one schedule is required for describing the general information for the whole banking entity's covered trading activity.
	Applicability	Applies to each trading desk engaged in covered trading activity	Adopted as proposed
Risk Factor Sensitivities	Metric	Generally the same	Metric removed
	Applicability	Applies to each trading desk engaged in covered trading activity	
VaR and Stressed VaR	Metric	Generally the same, but clarifies that the metric is calculated to a 99% confidence level over a one-day period	VaR metric adopted as proposed Stressed VaR metric removed
	Applicability	Applies to each trading desk engaged in covered trading activity, except that Stressed VaR would not be required from desks that exclusively hedge products excluded from the definition of "financial instrument"	Applies to each trading desk engaged in covered trading activity

[5] As explained in the Memorandum, the Final Rule also enacted new narrative reporting requirements, which are not included on this chart.

[6] Under the 2013 Rule, banking entities reported each metric for each trading desk engaged in covered trading activity.

METRIC UNDER 2013 RULE[6]		METRIC UNDER PROPOSAL	METRIC UNDER FINAL RULE
Comprehensive Profit and Loss Attribution	Metric	Generally the same, with elimination of requirement to calculate this metric's volatility	Generally adopted as proposed, with clarification that "residual" profit and loss attribution applies only to existing positions
	Applicability	Applies to each trading desk engaged in covered trading activity	Adopted as proposed
Inventory Turnover	Metric	Replaced with "Positions" metric that requires reporting of market value of securities and derivative positions	"Positions" metric generally adopted as proposed; requirement to report notional value of derivatives removed
	Applicability	Applies to trading desks that rely on the underwriting or market-making exemptions	Adopted as proposed
Customer-Facing Trade Ratio	Metric	Replaced with a "Transaction Volumes" metric that requires bucketing of transaction volumes by type of internal/external counterparty	"Transaction Volumes" metric generally adopted as proposed; however, categories merged for trades within same banking entity and trades with affiliated banking entity
	Applicability	Applies to trading desks that rely on the underwriting or market-making exemptions	Adopted as proposed
Inventory Aging	Metric	Limited to only "Securities" Inventory Aging	Inventory Aging and "Securities" Inventory Aging eliminated as standalone metrics
	Applicability	Applies to trading desks that rely on the underwriting or market-making exemptions	Applies to trading desks that rely on the underwriting or market-making exemption for securities activity and have inventory aging as a meaningful control should report in relation to the Internal Limits and Usage metric