ALERT MEMORANDUM

Agencies Finalize Elements of Volcker 2.0

Significant Revisions to Proprietary Trading and Compliance; Funds Proposal to Come

August 20, 2019

Today, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency approved a Final Rule adopting key changes to the proprietary trading and compliance program provisions of the Volcker Rule implementing regulations. The agencies also finalized revisions to certain covered fund requirements for which language was proposed in 2018. However, key elements of the covered funds provisions will be addressed in a new separate proposal to be issued by the Volcker Rule agencies. The three other Volcker Rule implementing agencies have not yet acted on the Rule.

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.

Below is a brief summary of the key changes in today's Final Rule.

Proprietary Trading

The Final Rule adopts a significantly more tailored approach to the scope of covered trading activities:

- As expected, the "**accounting prong**" proposed in 2018 is not included in the revised definition of "trading account".
- Institutions subject to the market risk capital rule can look only to the **market risk capital prong** and the dealer prong, and need not apply the short-term purpose prong.
  - Others (which may include entities controlled but not consolidated with a market risk capital parent) will be subject to the short-term purpose prong, but may elect to apply the market risk capital prong instead, provided the election is made with regard to a banking entity and all of its wholly owned subsidiaries.
- The Final Rule modifies the "**short-term purpose prong**" of the trading account definition by:
  - Eliminating the rebuttable presumption for financial instruments held for fewer than 60 days, and
  - Replacing it with a rebuttable presumption that instruments held for 60 days or longer are not within the short-term purpose prong.
- The agencies reaffirmed that the **dealer prong** covers only those positions that "require [the banking entity] to be so licensed or registered".

- The Final Rule creates a new, multi-factor "**trading desk**" definition. The agencies believe this definition will align with criteria used to establish trading desks for other operational, management and compliance purposes, and are likely to implement a similar definition when they finalize rules related to the Fundamental Review of the Trading Book.

The Final Rule expands the **exclusions from proprietary trading**:

- As proposed, exclusions are created for the following:
    - Additional **liquidity management** instruments, which will now encompass foreign exchange forwards, foreign exchange swaps and cross-currency swaps (with an expansion from the proposal to include non-deliverable cross currency swaps), provided the other requirements of the liquidity management exclusion are met.
        - Comments to eliminate some of the parameters of the required liquidity management plan or to expand the exclusion to other types of derivatives or instruments used in asset-liability management or treasury functions were rejected.
    - Transactions to correct **bona fide trade errors** (even though the less-than-60-day rebuttable presumption was also removed). The proposed requirement to transfer the error trade to a separately managed error account was <u>not</u> adopted.
- The agencies also created additional exclusions that relate to exclusions proposed in 2018:
    - Customer-driven **derivatives** by non-dealers that are **"matched" or backed-to-back** contemporaneously. This exclusion is intended to pick up the proposed exclusion for loan-related swaps, if they are performed back-to-back by a non-dealer. Dealer banks will have to rely on the greater flexibility afforded by changes to the market making exception.
        - With regard to unmatched loan-related swaps, the agencies suggested that, depending upon circumstances, these might be outside of the trading account.
    - In order to assist institutions subject to the short-term purpose prong, the agencies clarified that the following are also excluded from the definition of proprietary trading:
        - Any financial instrument that does not meet the definition of "trading asset" or "trading liability" under the applicable regulatory reporting form (determined as of the effective date of the rule), and
        - Any financial instrument used to hedge mortgage servicing rights or assets.

Market making and underwriting—Consistent with the proposal, under the Final Rule:

- A presumption of compliance with the reasonably expected near-term demand (RENTD) requirement will apply, provided the banking entity is trading within internal limits that are designed not to exceed RENTD.

- In contrast to the proposal, banking entities will not be subject to a requirement to report limit breaches and increases, provided banking entities maintain records that are available to the agencies upon request.

- Specific compliance program elements required in order to rely on these exemptions will not apply to entities that have moderate or limited TAL.

- The agencies provide some helpful preamble guidance related to inter-desk transactions, but not as much as commenters and the industry likely were expecting.

Risk-mitigating hedging—Consistent with the proposal, under the Final Rule:

- Requirements for a correlation analysis and for transactions to "demonstrably" reduce risk will be eliminated, and

- Specific compliance program and documentation requirements will not apply to entities that have moderate or limited TAL.

Changes to the **"trading outside the United States" (TOTUS)** exception were finalized as proposed:

- Eliminating restrictions on transactions conducted with or through a U.S. entity,

- Eliminating restrictions on financing of a TOTUS transaction by a foreign banking entity's U.S. branch or affiliate, and

- Eliminating the requirement that foreign bank personnel who "arrange, negotiate or execute" a TOTUS transaction be located outside the United States, but retaining the condition that banking entity personnel inside the U.S. not be decision-making personnel for TOTUS transactions.

<u>Covered Funds</u>

All changes to the covered funds provisions for which the agencies proposed specific language in 2018 were adopted, without changes. These include:

- **Removing the requirement to count interests in third-party covered funds acquired pursuant to the underwriting or market making exemption toward the 3% limits and the capital deduction**. This will provide 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 or not, which was previously necessary in order to accurately calculate the 3% aggregate limit and the capital deduction.

- Permitting a banking entity to hold a **covered fund interest as a hedge** when acting as an intermediary on behalf of a customer to facilitate the customer's exposure to the fund, provided that the hedge is held in accordance with the risk-mitigating hedging exception for proprietary trading. This change provides significant relief for fund-linked product businesses that were negatively impacted by the absence of authority in the 2013 rule to engage in such hedging transactions. The preamble also explicitly notes that such customer facilitation and related hedging activities do not necessarily constitute a "high-risk trading strategy".

- **Revising the SOTUS exemption** for foreign banking organizations' funds activities outside the United States by eliminating the restriction on financing from U.S. branches or affiliates and adopting the interpretation of the U.S. marketing restriction in FAQ #13, which generally permits foreign banks to invest in third party funds from outside the United States as long as the foreign bank does not participate in an offering of the fund to U.S. persons.

The Final Rule does not include any covered funds provisions that were not specifically proposed in the 2018 release. This leaves other key issues related to covered funds to be addressed in the pending proposed rule, including 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), revisions to the Super 23A prohibition on certain transactions with related covered funds, and the definition of foreign public funds.

The preamble cites a number of comments that it indicates are being considered and will be addressed in the covered funds proposal, including (among others) whether direct investments made alongside a covered fund should be aggregated with direct investments in a fund for purposes of the 3% per-fund limit and whether the aggregate 3% limit should only be measured at the top-tier parent for a foreign banking entity.

<u>Compliance Programs, CEO Attestations and Metrics Reporting</u>

The Final Rule retains the three-tiered approach to compliance program requirements based on the size of an institution's gross trading assets and liabilities (TAL), with several key revisions:

- The threshold for **"significant" TAL** institutions was raised from **$10 billion to $20 billion**.
    - While this change affects very few institutions currently, the preamble cites commenters' concerns about institutions that are close to the $10 billion threshold and might exceed it in the near future, perhaps just temporarily due to market events or unusual customer demands.
    - The preamble also notes that 93 percent of trading assets and liabilities in the U.S. banking system are held by banking entities with over $20 billion in TAL, and 99 percent are held by institutions that are either "significant" or "moderate" TAL institutions under the Final Rule.
- For foreign banks, the **TAL calculation for all thresholds will be based on their combined U.S. operations only**. Under the proposal, the threshold for "significant" TAL was based on U.S. operations, but the calculation for "limited" TAL that created a presumption of compliance and avoided a CEO attestation requirement was based on global TAL. This change in the Final Rule reverses what would have been a significant expansion of the CEO attestation requirement under the proposed rule to many foreign banks with limited U.S. operations.
- The **CEO attestation will apply only to "significant" TAL banking entities**, rather than to both "moderate" and "significant" TAL banks as proposed.
- The TAL calculation will exclude all financial instruments that are obligations of, or guaranteed by, the United States, or that are obligations, participations or other instruments of or guaranteed by an agency of the United States.

Consistent with the proposal's changes to the Volcker **compliance program** provisions:

- Only “significant” TAL firms will be required to implement the full six-pillar compliance program and metrics reporting regime.
- “Moderate” TAL firms (now between $1 billion and $20 billion) will only be required to implement a simplified program by incorporating Volcker Rule compliance into existing policies and procedures.
- Firms with less than $1 billion will benefit from a “presumption of compliance”.
- The prescriptive enhanced compliance requirements in Appendix B of the 2013 rule have been eliminated.

Metrics reporting requirements (applicable only to “significant” TAL institutions) have been further streamlined.

- Only a subset of the new metrics that the agencies had proposed adding in 2018 are included in the Final Rule.
- The agencies estimate that the revised metrics in the Final Rule will result in a 67 percent reduction in the number of data items and approximately 94 percent reduction in the total volume of data in comparison to the 2013 rule’s reporting requirements.
- **Reporting will be required quarterly** (within 30 days of quarter-end), rather than monthly as required by the 2013 rule and the proposal.

Notice and Response Procedures for Rebuttable Presumptions

The Final Rule adopts a uniform notice and response procedure related to several rebuttable presumptions in the Rule, including the presumption of compliance for limited TAL banks, the presumption that financial instruments held for 60 days or more are not in the trading account, and the presumption of compliance with the RENTD requirement in the underwriting and market making exemptions.

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