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OCC and FDIC Ease "Volcker Rule" Restrictions on Proprietary Trading: SEC, CFTC, and Federal Reserve Expected to Follow Suit

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On August 20, 2019, the Board of Directors of the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC") approved amendments to regulations implementing Section 13 of the Bank Holding Company Act of 1956 (12 USC 1851), known as the "Volcker Rule" or "Rule." These changes (referred to herein as the "Amendments" or the "Final Rule") narrow the scope of the Volcker Rule's prohibitions on banking entities' proprietary trading and investment in, or sponsorship of, private investment funds, clarify regulatory obligations, and reduce compliance burdens, especially for smaller banking entities with less active trading profiles. The other regulatory agencies responsible for implementing the Volcker Rule – the Securities and Exchange Commission ("SEC"), Commodity Futures Trading Commission ("CFTC"), and the Board of Governors of the Federal Reserve System – are expected to make parallel changes to their corresponding regulations. In this article we refer to the FDIC, the OCC and the Federal Reserve Board as the "banking agencies" and the banking agencies, the SEC and the CFTC collectively as the "agencies."

The Amendments have an effective date of January 1, 2020 and a mandatory compliance date of January 1, 2021. As a consequence, a banking entity may voluntarily comply, in whole or in part, with the changes to the rule beginning on January 1, 2020, subject to certain technical changes to be implemented by the agencies.

Practical Implications

- Securities firms and other companies that are affiliated with insured depository institutions and their affiliates may now find that the Amendments make it advantageous to enter new lines of business that previously required expensive and unwieldy supervisory structures.
- Foreign banking entities should benefit from a streamlined set of rules that eliminate the most restrictive elements of the regulations that define when a transaction takes place solely outside of the United States.
- The one-year delay will afford most banking entities ample time to adjust business practices and compliance programs, but the regulators will permit banking entities to comply with the new, more relaxed standards earlier.
- Although the Final Rule includes some changes related to covered funds, the regulators have indicated that they intend to propose additional, specific changes with respect to banking entities' investments in, and sponsorship of, such funds, including, for example, specific and separate definitions of a "hedge fund" and "private equity fund."

- Banking entities will now be able to enter and exit trading positions for their own accounts within 60 days without being presumed to be in violation of the ban on proprietary trading.

New Compliance Program Requirements and Thresholds

The existing Volcker Rule generally requires banking entities[1] to establish dedicated Volcker Rule compliance programs. The revised Rule will feature a three-tiered approach for compliance program requirements, determined by reference to a banking entity's total consolidated trading assets and liabilities (excluding the obligations of, or guaranteed by, the United States, any agency of the United States, or a United States government-sponsored enterprise).

- Banking entities with total consolidated trading assets and liabilities of at least $20 billion will be considered to have "significant" trading assets and liabilities. Banking entities with significant trading assets and liabilities would remain subject to current requirements for a six-pillar compliance program, an annual CEO attestation, and trade-metrics reporting. However, the most detailed and comprehensive compliance program standards, which previously applied to banking entities with total consolidated assets of $50 billion or more and that engage in significant trading activities, have been eliminated entirely for all entities.
- Banking entities with total consolidated trading assets and liabilities between $1 billion and $20 billion will be considered to have "moderate" trading assets and liabilities. These entities may satisfy their compliance program requirements by including appropriate references to Volcker Rule restrictions in applicable portions of their existing compliance policies and procedures.
- Banking entities with total consolidated trading assets and liabilities of less than $1 billion would be considered to have "limited" trading assets and liabilities. Banking entities with limited trading assets and liabilities would enjoy a presumption of compliance with the Volcker Rule's restrictions on proprietary trading, although regulators will examine them for compliance, and may rebut the presumption after providing notice and an opportunity to respond.

The regulators would retain a "backstop" right to require a banking entity in the latter two categories to implement specific Volcker Rule compliance standards if deemed appropriate or necessary.

Finally, the Rule changes eliminate certain reporting requirements for trading metrics and streamline reporting requirements for others. Under the Amendments, trade metrics will be submitted on a quarterly basis as opposed to monthly, with a reporting schedule of 30 days after the end of each quarter.

Changes to the Scope of the Prohibition on Proprietary Trading

The statutory text of the Volcker Rule generally prohibits any banking entity from engaging in "proprietary trading." Under the current Volcker Rule, a trade may be subject to the ban if it meets any of these three tests: (i) a short-term intent test, (ii) a market risk capital test,

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[1] In brief, a "banking entity" is defined as an FDIC-insured depository institution, any company that controls such an institution, any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any of the foregoing.

and/or (iii) a dealer test. The current regulations also establish certain limited exceptions and impose related compliance program requirements for banking entities.

(i) Short-Term Intent Test

The new Amendments eliminate the rebuttable presumption in the short-term intent test that a position held for fewer than 60 days is short-term proprietary trading activity. In its place, it substitutes an opposite presumption that a bank is not in violation of the proprietary trading ban for positions held for 60 days or longer. The agencies considered replacing the "short-term intent" test entirely with an objective test based on the valuation of financial instruments under accounting standards, but they opted not to take that step due to of concerns that the valuation test would be overly broad in scope.

(ii) Market Risk Capital Test

In addition, under the current market risk capital test, banking entities that calculate risk-based capital ratios under the federal banking agencies' market risk capital rules are deemed to be engaged in proprietary trading with respect to certain transactions that are both "covered positions" and "trading positions" under those rules. For such entities, the Amendments will eliminate the need for compliance with the short-term intent test. Moreover, under certain circumstances, a banking entity that is not subject to the market risk capital rules will be permitted to treat its trading activity as if it were subject to those rules and thereby avoid application of the short-term intent test.

(iii) Dealer Test

The Amendments also revise the dealer test, which currently deems transactions "for any purpose" by licensed or registered dealers in certain financial instruments to constitute proprietary trading.[2] The agencies have deleted the phrase" "for any purpose" from the rules, so that the dealer test will be restricted to transactions effected in connection with a dealing business, and will not apply to purchases or sales of financial instruments made in any other capacity. For example, if an insured depository institution is also registered as a swap dealer, and it purchases or sells a financial instrument in connection with activities that do not trigger swap dealer registration, such as lending, deposit-taking, or hedging business risks, that transaction will not constitute proprietary trading under the revised dealer test.

New and Revised Exceptions to the Prohibition on Proprietary Trading

The existing Volcker Rule includes a number of highly qualified exclusions from the definition of "proprietary trading," as well as exceptions from the prohibition. For example, transactions in securities pursuant to a banking entity's liquidity management plan are not "proprietary trading." In order to enhance the ability of banking entities to manage liquidity in the international context, the agencies have revised this exclusion to permit transactions not only in securities, but also in foreign exchange forwards, foreign exchange swaps, and cross-currency swaps.

Currently, there are exceptions to proprietary trading that permit banking entities to engage in securities underwriting and market making, provided that the positions of trading desks are

[2] Technically, under the Volcker Rule, dealer transactions are deemed to be proprietary trading, but are permitted pursuant to regulations that establish restrictive conditions and standards.

designed not to exceed the reasonably expected near-term demands of customers, clients or counterparties ("RENTD"). The revised regulations establish rebuttable presumptions of compliance with the RENTD standard where trading desks have implemented and adhere to internally-set limits that are established after consideration of the liquidity, maturity, and depth of market. In addition, underwriting and market making compliance program requirements will be eliminated for banking entities that do not have significant trading assets and liabilities.

The banking agencies have allowed for a greater degree of proprietary trading by applying the extensive conditions to an exception that permits banking entities to engage in risk-mitigating hedging activities only to those banking entities with "significant" trading assets and liabilities. These conditions will no longer include a requirement for correlation analyses. For other banking entities, the exception for trading in connection with hedging will only be subject to the condition that transactions be designed to reduce or significantly mitigate risk and be subject to ongoing recalibration.

Under the current Volcker Rule there is an exemption from the prohibition on proprietary trading which applies for transactions that are conducted "solely outside the U.S." (known as "trading outside the U.S." or "TOTUS"). The agencies have expanded the TOTUS exemption in response to complaints that the exception is too narrow. Specifically, a banking entity's U.S. branches and affiliates will be permitted to provide financing for those transactions. In addition, the requirements that prohibited transactions from being conducted with or through a U.S. entity, and which restricted the involvement of personnel located in the U.S., have been eliminated. Finally, the agencies have adopted new exclusions from the definition of "proprietary trading" for:

- Transactions made in error or made to correct errors. Moreover, banking entities would not be required to maintain a separately managed trade error account for the disposition of the financial instruments purchased in error;
- Contemporaneous matched swaps that are driven by customer interest, and that are entered into by banking entities that are not registered as swap dealers or security-based swap dealers;
- Transactions used to hedge mortgage servicing rights or mortgage servicing assets in accordance with a documented hedging strategy where trading in the underlying mortgage servicing rights is not prohibited by the rule; and
- Transactions that do not meet the definitions of a "trading asset" or "trading liability" under the banking entity's applicable reporting forms.

Covered Funds

The existing Rule permits certain underwriting, market making, and risk-mitigating hedging activities by banking entities with respect to a covered fund, as well as investment in or sponsorship of covered funds by foreign banking entities occurring solely outside the United States ("SOTUS"). The Final Rule implemented limited changes with respect to covered fund activities:

- The existing rules impose aggregate investment limits and capital deductions with respect to a banking entity's ownership interest in covered funds acquired or retained in accordance with the underwriting or market-making exemptions. However, the Final Rule

excluded the value of third-party covered funds (i.e., covered funds that are not sponsored, advised, organized, or offered by the banking entity) from these limits.

- The Amendment also expands the scope of a banking entity's risk-mitigating hedging activities involving ownership interests in covered funds by permitting a banking entity to acquire or retain an ownership interest in a covered fund when acting as an intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund.
- The existing rules permit a foreign banking entity to acquire or retain an ownership interest in, or sponsor, a covered fund if those investments and activities occur solely outside of the United States. As with the TOTUS exemption described above, the Final Rule will now permit financing for investments in covered funds under the SOTUS exemption to be provided by a banking entity's U.S. branches and affiliates.
- The Final Rule also clarifies that, for purposes of the SOTUS exemption, an ownership interest in a covered fund is not "offered for sale or sold to a resident of the United States" if it is not sold pursuant to an offering that targets residents of the United States in which the banking entity relying on the SOTUS exemption participates. The Final Rule also codifies regulatory guidance that, if the banking entity or an affiliate sponsors, or serves as the investment manager, investment adviser, commodity pool operator, or commodity trading advisor to a covered fund, then it will be deemed to participate in any offer or sale by the covered fund of its ownership interests.

Next Steps

The FDIC indicated that the agencies implementing the Volcker Rule intend to issue an additional notice of proposed rulemaking that would propose further changes to the restrictions on covered fund investments and activities and other issues related to the treatment of investment funds. These proposed changes will include revisions to limitations on relationships between a banking entity and a covered fund for purposes of section 23A of the Federal Reserve Act, which regulates a bank's relations with its affiliates.

Banking entities should consider how the Amendments will affect their trading and fund-related activities, and evaluate whether to defer compliance to the effective date or to comply voluntarily prior to such compliance date as permitted by the Amendments.

Conclusion

The Amendments to the Volcker Rule regulations are a welcome development for banking entities and their affiliates around the globe. These changes will permit enhanced trading in financial markets on a domestic and international basis, and have a positive effect on global liquidity. In addition, they remove certain impediments for firms that are seeking to grow their business or add new business lines. The global financial services team at K&L Gates continues to follow these and other upcoming developments with respect to the Volcker Rule, including potential changes to the restrictions on banking entities owning or controlling covered funds.

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