The Debrief

VOLCKER RULE: CHANGES AND QUESTIONS

May 31, 2018

Yesterday, the Federal Reserve Board proposed revisions (the "Proposal") to the regulations implementing section 13 of the Bank Holding Company Act (referred to as the "Volcker Rule") and asked questions on potential additional changes. Below are our preliminary takeaways on select issues. We anticipate providing a comprehensive summary of the Proposal in the future, covering the issues below in more detail and additional issues raised by the Proposal. A redline showing proposed changes to the regulatory text is available here.

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Proposed Changes

- **Compliance Tailored by Size**: The Proposal would establish three tiers of banking entities, based on dollar amount of trading assets and liabilities (excluding U.S. government or guaranteed obligations) and each subject to differing compliance obligations. The "enhanced minimum standards" (referred to as Appendix B) for compliance would be eliminated.
  - *Significant trading assets and liabilities*: ≥ $10 billion, measured for U.S. banking entities on a global basis and for foreign banking entities with respect to U.S. operations. Subject to the most stringent compliance requirements.
  - *Moderate trading assets and liabilities*: Not in the other two categories. Less stringent compliance requirements.
  - *Limited trading assets and liabilities*: < $1 billion, measured on a global basis for U.S. and foreign banking entities. Rebuttable presumption of compliance.
- **Definition of Trading Account**: The Proposal would modify the Volcker Rule's three-prong definition of "trading account" by: (1) replacing the current "short-term intent prong" with a more objective "accounting prong" that covers purchases or sales of financial instruments recorded at fair value on a recurring basis under applicable accounting standards; (2) creating a presumption of compliance for

trading desks subject only to the accounting prong and whose sum of the absolute values of daily profit and loss for the preceding 90 days is $25 million or less; and (3) eliminating the 60-day rebuttable presumption. Instruments generally included in the accounting prong would be derivatives, trading securities, and available-for-sale securities. The market-risk capital prong would be revised to add certain foreign banking entities.

- **Underwriting and Market Making-related Activities**: The Proposal would modify the exemptions for underwriting and market making-related activities by allowing banking entities to set internal risk limits to show that positions are designed not to exceed the reasonably expected near term demand of clients, customers, or counterparties (RENTD). Banking entities would no longer have to include the value of ownership interests of third-party covered funds held as underwriting or market making positions for purposes of the aggregate covered fund ownership limit and capital deduction.

- **Risk-Mitigating Hedging**: The Proposal would remove the requirements for correlation analysis and that a banking entity show a hedge "demonstrably reduces" risk. For banking entities with significant trading assets and liabilities, commonly used hedges would not be subject to documentation requirements that otherwise apply to cross-desk hedges and aggregated hedges. Banking entities would be permitted to hold covered fund interests to hedge fund-linked products.

- **Trading Outside of the United States ("TOTUS")**: The Proposal would broaden the TOTUS exemption. U.S. personnel would be permitted to help arrange and negotiate transactions, and trading would be permitted with U.S. counterparties. There would be no prohibition on financing from U.S. offices or affiliates. The decision to trade and principal risks and actions of transactions would need to be located outside of the United States.

- **Solely Outside of the United States ("SOTUS") Fund Exemption**: The Proposal would codify staff FAQ No. 13 (see our prior Client Update, here), which provides that SOTUS is available for investing in covered funds, so long as the foreign banking entity does not participate in the offer or sale of ownership interests to U.S. residents. There would be no restriction on financing from U.S. offices or affiliates.

- **Registered Fund Seeding**: Staff FAQ No. 16 would be reaffirmed, including that there is no "maximum prescribed period" for seeding a registered investment company or foreign public fund (see our prior Client Update, here).

- **Foreign Exchange ("FX") Swaps and Forwards**: FX forwards, FX swaps, and physically settled cross-currency swaps would be outside the scope of the Volcker Rule's proprietary trading prohibition (as permitted liquidity management).

- **CEO Attestation**: Would remain only for banking entities with significant and moderate trading assets and liabilities.

Questions on Additional Potential Changes

- **Definition of Covered Fund**: No changes proposed; comments requested.

- **Registered Fund and Foreign Excluded Fund Banking Entity Status**: No changes proposed to address the "banking entity" status of registered investment companies, foreign public funds, and foreign excluded funds; comments requested, including as to the definition of foreign public fund. No-action relief for "qualifying foreign excluded funds" is extended for one year, until July 21, 2019 (see our prior Client Update, here).

- **Super 23A**: No changes proposed; comments requested.

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