Volcker Rule: Version 2.0, Final Rule Round 1

August 21, 2019

Yesterday, the Federal Deposit Insurance Corporation and Comptroller of the Currency approved revisions to the regulations implementing section 13 of the Bank Holding Company Act, referred to as the "Volcker Rule."[1] The final rule—sometimes called Volcker Rule 2.0—deals mostly with proprietary trading, compliance and metrics issues and adopts as proposed covered funds changes for which the agencies had proposed rule text. In general, the final rule reflects the agencies' intent to resolve ambiguity, overbroad application, and unduly complex and inefficient requirements. The agencies anticipate a second round of proposed revisions to deal with a broader set of covered funds issues. Below are our preliminary takeaways on key matters in the final rule.

We anticipate providing a comprehensive summary of the final rule in the future. A redline showing changes to the regulatory text is available here.

PROPRIETARY TRADING

Trading account and trading desk.

- *MRCR and short-term intent prongs*. The accounting prong was not adopted. The final rule retains the short-term intent prong but provides that banking entities subject to the market risk capital rule ("MRCR") prong are not also subject to the short-term intent prong. Banking entities that are not subject to the MRCR may elect to apply this prong instead of the short-term intent prong. The agencies declined to modify the MRCR prong to incorporate foreign market risk capital frameworks.

- *60-day rebuttable presumption*. The final rule reverses the 60-day rebuttable presumption such that financial instruments held for 60 days or longer are presumed not to be within the short-term intent prong, as long as the banking entity does not transfer substantially all of the risk of the financial instrument within 60 days of the purchase or sale.

[1] The other implementing agencies are expected to follow suit shortly.

- *Dealer prong*. The final rule retains the 2013 final rule's dealer prong without any substantive changes, and the agencies reaffirmed how to interpret it.

- *Trading desk*. A new multi-factor definition that incorporates aspects of the approach in the Basel Committee's fundamental review of the trading book was added; banking entities subject to the MRCR may rely on the definition that they use for MRCR purposes.

Exclusions.

- *Liquidity risk management exclusion*. The exclusion is expanded to cover the purchase or sale of foreign exchange forwards, foreign exchange swaps, and cross-currency swaps (including non-deliverable cross-currency swaps) entered into by a banking entity for the purpose of liquidity management in accordance with a documented liquidity management plan.

- *Error trades*. An exclusion is added for error trades and correcting transactions; unlike the proposal, there is no requirement to use a separately managed error trade account.

- *Matched derivatives transactions*. Customer-driven swaps and security-based swaps and contemporaneous matching trades are excluded if: (i) the banking entity retains no more than minimal price risk; and (ii) the banking entity is not a registered dealer.

- *Hedges of mortgage servicing rights*. Purchases and sales of financial instruments to hedge mortgage servicing rights or mortgage servicing assets in accordance with a documented hedging strategy are excluded.

- *Non-trading assets or liabilities*. Any purchase or sale of a financial instrument that does not meet the definition of "trading asset" or "trading liability" under the applicable reporting form as of January 1, 2020 is excluded.

Exemptions.

- *Underwriting and market making-related activities*. There is a new compliance presumption for trading within risk limits set by the banking entity. Breaches and limit increases do not require reporting; instead banking entities are required to maintain records that need to be available to regulators on request.

- *Risk-mitigating hedging*. The requirements for correlation analysis and that a banking entity show a hedge "demonstrably reduces" risk were removed. For banking entities with significant trading assets and liabilities (see below), commonly used hedges would not be subject to documentation requirements that otherwise apply to cross-desk hedges and aggregated hedges.

- *Trading outside of the United States ("TOTUS")*. The TOTUS exemption was revised. 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.

COVERED FUNDS

Underwriting and market-making. Banking entities 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. A third-party covered fund is one that the banking entity does not sponsor, advise, or organize and offer. The agencies continue to consider whether this approach should be extended to other covered funds, such as advised funds, and intend to address this issue in the round two covered fund proposal.

Risk-mitigating hedging exemption. Banking entities would be permitted to hold covered fund interests to hedge fund-linked products. The agencies state that they do not believe that this type of hedging activity "necessarily" constitutes a high-risk trading strategy that could threaten the safety and soundness of the banking entity.

Solely outside the United States ("SOTUS") fund exemption. The final rule adopts the proposal to remove the financing prong from the SOTUS fund exemption and adds to the rule text language reflecting the marketing restriction guidance in FAQ No. 13.

Registered fund and foreign excluded fund banking entity status. The final rule does not amend the definition of banking entity. The agencies also state that they are not modifying or revoking any previously issued staff FAQs or guidance related to the banking entity status and seeding of registered investment companies, foreign public funds, and foreign excluded funds. The agencies do not revise the statement emphasized in the proposal that FAQ No. 16 does not set "any maximum prescribed period for a RIC or FPF seeding period."

Super 23A prime brokerage exemption. FAQ No. 18's guidance that a banking entity must provide the annual CEO certification required under the prime brokerage exemption by March 31 of each year is codified.

COMPLIANCE DATE AND PROGRAM REQUIREMENTS

Compliance date. The final rule's effective date is January 1, 2020 and mandatory compliance date is January 1, 2021; voluntary early compliance is permitted.

Compliance tailored by size. The final rule, like the proposal, establishes three tiers of banking entities, based on dollar amount of trading assets and liabilities (excluding financial instruments that are obligations of or guaranteed by the United States, its agencies, or a government-sponsored enterprise) and each subject to differing compliance obligations. The final rule raises the threshold for "significant" trading assets and liabilities from $10 billion to $20 billion. Trading assets and liabilities are measured on a worldwide consolidated basis for U.S. banking entities and using combined U.S. operations for foreign banking organizations.

- *Significant trading assets and liabilities*: ≥ $20 billion. Subject to the most stringent compliance requirements, including CEO attestation.
- *Moderate trading assets and liabilities*: Not in the other two categories. Less stringent compliance requirements; no CEO attestation.
- *Limited trading assets and liabilities*: < $1 billion. Benefit from a rebuttable presumption of compliance; no CEO attestation.

Quantitative metrics. The final rule makes a number of changes to the reporting and recordkeeping requirements applicable to banking entities with significant trading assets and liabilities.

- *Metrics*. The final rule: (1) largely retains the metrics for "Risk and Positions Limits and Usage" (renamed the "Internal Limits and Usage"); "Value-at-Risk"; and "Comprehensive Profit and Loss Attribution"; (2) replaces the "Inventory Turnover" and "Customer-Facing Trade Ratio" metrics with "Positions" and "Transaction Volumes" metrics, respectively, which only would be applicable to trading desks that rely on the underwriting or market making-related activities exemptions; and (3) eliminates the "Risk Factor Sensitivities" and "Inventory Aging" metrics, as well as the requirement to report "Stressed Value-at-Risk."
- *Information schedules*. The final rule also introduces an "Internal Limits Information Schedule" and a "Risk Factor Attribution Information Schedule" that provide identifying and description information relevant to the "Internal Limits and Usage" and "Comprehensive Profit and Loss Attribution" metrics, respectively.

- *Descriptive information and narrative statements*. The final rule introduces a requirement to provide descriptive information for each trading desk engaged in covered trading activity; banking entities have the option to provide narrative statements to supplement their submissions. This requirement is streamlined compared to the proposal.

- *Timing*. The final rule reduces the frequency of required metrics reports from monthly to quarterly, to be submitted within 30 calendar days of quarter-end.

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Please do not hesitate to contact us with any questions.

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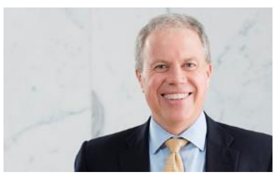

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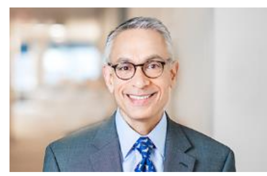

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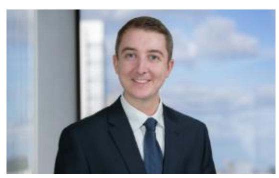

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