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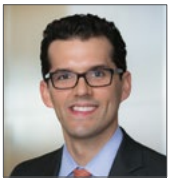
Understanding the 2019 Revisions to the Volcker Rule

The federal financial regulatory agencies recently approved significant revisions to the proprietary trading and covered funds provisions of the Volcker Rule, among other changes. Banking entities should ensure they understand these revisions and have the requisite compliance policies and procedures in place.



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In October 2019, the Board of Governors of the Federal Reserve System became the last of the five federal financial regulatory agencies (agencies) to approve revisions (2019 Final Rule) to the regulations implementing Section 13 of the Bank Holding Company Act of 1956, known as the Volcker Rule. The Volcker Rule generally prohibits banking entities from engaging in proprietary trading or investing in or sponsoring hedge funds or private equity funds. The 2019 Final Rule follows a July 2018 proposal (2018 Proposal), which was the subject of significant criticism throughout the comment process. The 2019 Final Rule addresses many of these criticisms, including by:

- Expanding exclusions to and exemptions from the proprietary trading prohibition.
- Removing the proposed "accounting prong" from the trading account definition.

The agencies also adopted without change certain revisions to the covered funds provisions contemplated by the 2018 Proposal, although most of the issues pertaining to covered funds will be the subject of a future proposed rulemaking.

The 2019 Final Rule is effective on January 1, 2020, with a mandatory compliance date of January 1, 2021. Notably, voluntary early compliance is permitted "in whole or in part."

This article reviews the most significant changes contemplated by the 2019 Final Rule to the proprietary trading and covered funds provisions of the Volcker Rule. Although the 2019 Final Rule also streamlined metrics reporting requirements and tailored the Volcker Rule's compliance program requirements, these changes are not addressed in this article.

Search Understanding the 2019 Revisions to the Volcker Rule for the complete online version of this article, including information on compliance program requirements.

Search Summary of the Dodd-Frank Act: The Volcker Rule for more on the Volcker Rule generally.

PROPRIETARY TRADING

Changes introduced by the 2019 Final Rule to the proprietary trading provisions of the Volcker Rule relate to:

- The trading account definition.
- The trading desk definition.
- Exclusions to the proprietary trading definition.
- Permitted underwriting and market making-related activities.
- Permitted risk-mitigating hedging.
- The trading outside of the US (TOTUS) exemption.

TRADING ACCOUNT DEFINITION

The Volcker Rule defines proprietary trading as "engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments." Under both the 2013 regulations implementing the Volcker Rule (2013 Final Rule) and the 2019 Final Rule, trading account is defined using a three-prong test:

- **Short-term intent prong.** This prong applies to any account used by a banking entity to purchase or sell one or more financial instruments principally for the purpose of:
  - short-term resale;
  - benefitting from actual or expected short-term price movements;
  - realizing short-term arbitrage profits; or
  - hedging any of the above.
- **Market risk capital prong.** This prong applies to the purchase or sale of financial instruments that are both "covered positions" and "trading positions" (or hedges of other covered positions) under the federal banking agencies' market risk capital rule.
- **Dealer prong.** This prong applies to the purchase or sale of financial instruments by a banking entity that is licensed or registered, or required to be licensed or registered, as a dealer, swap dealer, or security-based swap dealer, to the extent that the instrument is purchased or sold in connection with activities that require the banking entity to be licensed or registered as such, as well as equivalent foreign activity.

Short-Term Intent Prong

Under the 2013 Final Rule, the short-term intent prong was subject to a rebuttable presumption that a purchase or sale of a financial instrument was for the trading account if the banking entity held the financial instrument for fewer than 60 days or substantially transferred the risk of the position within 60 days of the purchase or sale. The 2019 Final Rule retains the short-term intent prong, but reverses its rebuttable presumption. A purchase or sale of a financial instrument is presumed not to be for the trading account if the banking entity holds the financial instrument for 60 days or longer, as long as the banking entity does not transfer substantially all the risk of the position within 60 days of the purchase or sale.

The agencies stated that the previous rebuttable presumption had captured many activities that should not have been included in the definition of proprietary trading, such as a foreign branch of a US banking entity purchasing a foreign sovereign debt obligation with a remaining maturity of fewer than 60 days to meet foreign regulatory requirements.

Notably, the agencies declined to adopt the much-criticized proposed accounting prong in lieu of the short-term intent prong, which would have provided that a trading account included any account used by a banking entity to purchase or sell one or more financial instruments recorded at fair value on a recurring basis under applicable accounting standards. The agencies agreed with commenters that the accounting prong would have inappropriately captured many activities that the Volcker Rule was not intended to address.

Market Risk Capital Prong

The 2013 Final Rule applied the market risk capital prong to a banking entity if any affiliate was subject to the market risk capital rule. In contrast, the 2019 Final Rule applies the market risk capital prong to a banking entity if it, or any affiliate with

which the banking entity is consolidated for regulatory reporting purposes, calculates risk-based capital ratios under the market risk capital rule.

To explain the change, the agencies provide as an example a broker-dealer that is not consolidated with its parent bank holding company, where the trading positions of the broker-dealer are not included in the bank holding company's trading positions in its Form FR Y-9C. Under the 2019 Final Rule, even though the broker-dealer is affiliated with an entity (the parent bank holding company) that calculates risk-based capital ratios under the market risk capital rule, the broker-dealer would not be subject to the market risk capital prong because the broker-dealer is not consolidated with the parent for regulatory reporting purposes. Therefore, the broker-dealer would be required to apply the short-term intent prong and, where applicable, the dealer prong, or may elect to opt-in to apply the market risk capital prong, as described below.

In response to comments that the short-term intent prong and market risk capital prong were redundant, the 2019 Final Rule provides that banking entities subject to the market risk capital prong are no longer subject to the short-term intent prong. The agencies declined to adopt a proposed revision to the market risk capital rule that would have incorporated foreign market risk capital frameworks.

Additionally, banking entities that are not subject to the market risk capital prong may instead elect to apply it in lieu of the short-term intent prong. This election must be made with respect to a banking entity and all of its wholly owned subsidiaries. However, the relevant agency may subject a banking entity affiliate that is not a wholly owned subsidiary to consistent treatment if the agency determines it is necessary to prevent evasion, pursuant to notice and response procedures that are applicable to other aspects of the 2019 Final Rule. The 2019 Final Rule provides a one-year transition period for banking entities that comply with the short-term intent prong that subsequently become subject to the market risk capital prong.

Dealer Prong

The 2019 Final Rule does not make changes to the dealer prong, but the agencies reaffirmed that the dealer prong does not capture activities conducted by a dealer that do not require the banking entity to be registered as a dealer. For example, a purchase of securities by a banking entity purely for investment purposes (not rendering the banking entity a "dealer" under Section 3(a)(5) of the Securities Exchange Act of 1934) would not be for the trading account under the dealer prong.

TRADING DESK DEFINITION

Under the 2013 Final Rule, trading desk was defined as "the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof." Consistent with the 2018 Proposal, the revised trading desk definition introduces a multi-factor approach that seeks to align the definition with the criteria used to establish trading desks for other operational, management, and compliance purposes.

Additionally, the revised definition includes a second prong that requires banking entities subject to the market risk capital rule (or that are consolidated affiliates for regulatory reporting purposes of a banking entity subject to the market risk capital rule) to adopt the same delineation of trading desks for purposes of the Volcker Rule as they adopt under the market risk capital rule. Although the current market risk capital rule does not include a definition of trading desk, the federal banking agencies indicated that they expect to implement the Basel Committee on Banking Supervision's revised market risk capital standards, which include this definition.

EXCLUSIONS TO THE PROPRIETARY TRADING DEFINITION

The 2019 Final Rule provides for exclusions to the proprietary trading definition relating to:

- Liquidity risk management.
- Error trades.
- Customer-driven matched derivatives transactions.

Consistent with the 2018 Proposal, the revised trading desk definition introduces a multi-factor approach that seeks to align the definition with the criteria used to establish trading desks for other operational, management, and compliance purposes.

- Hedges of mortgage servicing rights.
- Non-trading assets or liabilities.

Liquidity Risk Management

The 2013 Final Rule excluded from the definition of proprietary trading the purchase or sale of securities for the purpose of liquidity management in accordance with a documented liquidity management plan, provided that the banking entity meets certain additional conditions. The liquidity management exclusion was limited to purchases or sales of securities and excluded other financial instruments commonly used for liquidity management, including foreign exchange products.

The 2019 Final Rule expands this aspect of the liquidity risk management exclusion to include certain foreign exchange forwards and swaps (as defined in the Commodity Exchange Act) and cross-currency swaps, including physically settled and non-deliverable (cash-settled) cross-currency swaps. Foreign branches and subsidiaries of US banking entities subject to foreign liquidity requirements may rely on the liquidity management exclusion when trading foreign exchange products to manage currency risk arising from holding liquid assets in foreign currencies.

The agencies declined, however, to further expand the liquidity management exclusion and retained the requirement to have a documented liquidity management plan.

Error Trades

The 2019 Final Rule finalizes a substantially similar proposed exclusion for error trades and correcting transactions (transactions that would otherwise be proprietary trading but are entered into to correct trading errors in the course of conducting a permitted or excluded activity or a subsequent correction related to such a trade). The agencies included this exclusion for clarity even though the 2019 Final Rule reverses the 60-day rebuttable presumption that previously might have captured an error trade.

The final exclusion departs from the 2018 Proposal by not requiring a banking entity to transfer erroneously purchased or sold financial instruments to a separately managed trade error account for disposition. The agencies also declined to adopt certain reporting, auditing, and testing requirements that were suggested by some commenters. The agencies will monitor this exclusion for evasion, as the magnitude or frequency of errors could indicate trading activity is inconsistent with the exclusion.

Customer-Driven Matched Derivatives Transactions

The 2019 Final Rule adds an exclusion for customer-driven swaps and security-based swaps and matching trades if the following conditions are met:

- Matched transactions are entered into contemporaneously.
- The banking entity retains no more than minimal price risk.
- The banking entity is not a registered dealer, swap dealer, or security-based swap dealer.

Further, the exclusion is available only where one of the two matched swaps is entered into for a customer's "valid and independent business purposes." This new exclusion includes not only loan-related swaps commonly entered into by banking entities in connection with a loan, but also a wide range of other customer-driven matched derivatives activities. Under the 2013 Final Rule, trading now covered by this exclusion often would have triggered the short-term intent prong's rebuttable presumption and would have had to meet the requirements for the market making-related activities or risk-mitigating hedging or other exemption.

Hedges of Mortgage Servicing Rights

The 2019 Final Rule introduces an exclusion for purchases and sales of financial instruments to hedge mortgage servicing rights or mortgage servicing assets in accordance with a documented hedging strategy. This exclusion is meant to provide parity between banking entities subject to the short-term intent prong and market risk capital prong, as the market risk capital rule explicitly excludes intangibles, including servicing assets, from the definition of covered position.

Non-Trading Assets or Liabilities

The 2019 Final Rule introduces an exclusion for the purchase or sale of a financial instrument that does not meet the definition of trading asset or trading liability under the applicable reporting form (for example, Call Report or Form FR Y-9C) as of January 1, 2020. (The agencies specified an "as-of" date in anticipation of potential changes to reporting forms that materially change how trading assets and trading liabilities are reported.) This exclusion is meant to simplify compliance with the short-term intent prong and provide parity between banking entities subject to the short-term intent prong and those subject to the market risk capital prong.

Under the market risk capital rule, the term covered position includes trading assets and trading liabilities, as reported on the relevant regulatory reporting form, that meet certain additional conditions. The only positions not required to be reportable as trading assets and trading liabilities are certain foreign exchange and commodities positions. Therefore, by construction, most trading covered by the market risk capital prong is reportable as a trading asset or trading liability on an applicable reporting form.

PERMITTED UNDERWRITING AND MARKET MAKING-RELATED ACTIVITIES

The Volcker Rule contains exemptions from the prohibition on proprietary trading for underwriting and market making-related activities to the extent that these activities are designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties (RENTD).

The agencies acknowledged that the 2013 Final Rule created significant compliance difficulties with respect to these exemptions due to the extent and complexity of the requirements, particularly the RENTD requirement. Therefore, the 2019 Final Rule introduces a presumption of compliance to

provide increased certainty regarding whether a trading desk's activity is designed not to exceed RENTD. The 2019 Final Rule also tailors the compliance requirements to a banking entity's size, complexity, and type of activities.

Notably, the 2018 Proposal would have required a banking entity relying on the presumption to promptly report limit breaches and increases to the relevant agency. The 2019 Final Rule instead requires banking entities to maintain and make available upon request records of any breaches or increases and follow certain internal escalation and approval procedures. Importantly, a breach or increase would not necessarily defeat the presumption of compliance, provided that the banking entity takes immediate action to bring the trading desk into compliance and follows certain established internal procedures.

Under the 2019 Final Rule, a banking entity is presumed to comply with the RENTD requirement if it establishes, implements, maintains, and enforces the internal limits for each relevant trading desk.

For underwriting activities, a banking entity's internal RENTD limits must be based on three factors:

- The amount, types, and risks of its underwriting position.
- The level of exposures to relevant risk factors arising from its underwriting position.
- The period of time that a financial instrument may be held.

For market making-related activities, a banking entity's internal RENTD limits must be based on four factors:

- The amount, types, and risks of its market-maker positions.
- The amount, types, and risks of the products, instruments, and exposures that the trading desk may use for risk management purposes.
- The level of exposures to relevant risk factors arising from its financial exposure.
- The period of time that a financial instrument may be held.

Although these factors also were used in the 2013 Final Rule, the 2019 Final Rule dispenses with a requirement that the RENTD limit for market-making purposes be based on a "demonstrable analysis of historical customer demand." The agencies emphasized that although RENTD limits were required to take into account certain factors, including "the liquidity, maturity, and depth of the market for the relevant types of financial instruments," overall, the amended approach is "intended to provide banking entities with the flexibility to determine appropriate limits for market-making related activities." The agencies noted that certain factors may not be effective for market-making in derivatives.

The 2019 Final Rule also modifies the 2013 Final Rule's generally applicable compliance requirements for the underwriting and market-making exemptions, adopting a tiered approach. Considering the complexity of these exemptions and the fact that substantially all trading assets and liabilities are held by the largest banking entities, the agencies decided only to require banking entities with significant trading assets and liabilities to implement exemption-specific compliance programs. These banking entities must maintain an internal compliance program addressing, in addition to the 2013 Final Rule's requirements:

- Trading desk RENTD limits.
- Written authorization procedures for limit breaches.
- Internal controls and ongoing monitoring of trading desk compliance with its limits.

In response to comments, the agencies confirmed that a banking entity may treat affiliate desks as "clients, customers or counterparties" for purposes of these exemptions, but clarified that banking entities generally may not treat such desks as "clients, customers or counterparties" for purposes of determining a trading desk's RENTD.

PERMITTED RISK-MITIGATING HEDGING

The 2013 Final Rule provided an exemption from the prohibition against proprietary trading for risk-mitigating hedging activities that are designed to reduce the specific risks to a banking entity in connection with, and related to, individual or aggregated positions, contracts, or other holdings. In response to comments that the requirements to conduct "correlation analysis" and to show that risk-mitigating hedging activity "demonstrably reduces or otherwise significantly mitigates" specific risks were too onerous, the 2019 Final Rule gives banking entities additional flexibility.

Banking entities with significant trading assets and liabilities now may justify their reliance on the exemption using any type of analysis and independent testing designed to ensure that risk-mitigating hedging activities are reasonably expected to reduce or otherwise significantly mitigate specific risks to the banking entity. Other banking entities no longer must undertake this analysis to justify their reliance on the exemption.

Further, the 2019 Final Rule removes language requiring that banking entities show that risk-mitigating hedging activities "demonstrably" reduce or otherwise significantly mitigate specific risk, instead merely requiring that hedging activity be reasonably expected to reduce such risk. For all banking entities, however, hedging activities still must be subject to ongoing recalibration to ensure compliance with the exemption.

The 2019 Final Rule also tailors compliance requirements to a banking entity's trading activities. These changes are most favorable for banking entities without significant trading assets and liabilities. For these banking entities, the 2019 Final Rule eliminates the requirements for:

- A separate internal compliance program for risk-mitigating hedging.
- Limits on compensation arrangements for persons performing risk-mitigating activities.
- Documentation for certain risk-mitigating activities.

For banking entities with significant trading assets and liabilities, compliance requirements also are streamlined, but to a lesser extent. These banking entities still must comply with enhanced documentation requirements regarding their cross-desk and aggregated hedges. However, the 2019 Final Rule adds an exception to the enhanced documentation requirements for financial instruments identified on a written list of pre-approved financial instruments commonly used by the trading desk for the specific type of hedging activity at issue, as long as the hedging activity complies with appropriate written, pre-approved limits for that trading desk at the time a financial instrument is purchased or sold. Banking entities with less than significant trading assets and liabilities will not be required to comply with these enhanced documentation requirements.

TOTUS EXEMPTION

The Volcker Rule permits certain foreign banking entities to engage in proprietary trading activities that occur solely outside of the US. The 2013 Final Rule included several conditions to use the TOTUS exemption. In particular:

- A foreign banking entity's US-based personnel were prohibited from "arranging, negotiating or executing" (referred to as own ANE) a transaction that was made in reliance on TOTUS.
- Transactions were prohibited if they were made "with or through" any US entity. The so-called with or through prohibition was subject to various exemptions, including one for transactions with the foreign operations of a US entity if no US-based personnel of the US entity were involved in the "arrangement, negotiation or execution" of the transaction (referred to as counterparty ANE).

The 2019 Final Rule eliminates some of these conditions, including the own ANE and counterparty ANE limitations, refocusing the TOTUS exemption on where decisions are made as compared to where personnel who are engaged in arranging and negotiating transactions are based. In particular, a foreign banking entity may trade in reliance on the TOTUS exemption if both:

- The trade (and any related hedge) is not booked to or accounted for by a US branch or affiliate.
- The location of the banking entity (and any relevant personnel) making the decision to trade is outside of the US.

The 2019 Final Rule therefore also eliminates the 2013 Final Rule's requirement that no financing for the banking entity's purchases or sales is provided, directly or indirectly, by any branch or affiliate that is located in the US or organized under US law. Further, the TOTUS exemption does not preclude a foreign banking entity from engaging a non-affiliated US investment adviser, as long as the actions and decisions of the banking entity as principal occur outside of the US. These modifications provide greater flexibility to foreign banking entities that rely on the TOTUS exemption, thereby implementing the statute's extraterritorial limit for the Volcker Rule.

COVERED FUNDS

The agencies adopted, without change, covered funds provisions which had been proposed in the 2018 Proposal. Many issues, however, including possible revisions to the definition of covered fund, banking entity status questions, and changes to Super 23A, are expected to be addressed in a future proposed rulemaking.

Changes introduced by the 2019 Final Rule to the covered funds provisions of the Volcker Rule relate to:

- Permitted underwriting and market making-related activities.
- Permitted risk-mitigating hedging.
- The solely outside of the US (SOTUS) exemption.
- The Super 23A prime brokerage exemption.

PERMITTED UNDERWRITING AND MARKET MAKING-RELATED ACTIVITIES

The 2013 Final Rule provided an exemption to the covered fund prohibition for underwriting or market-making in covered fund ownership interests provided that certain conditions were satisfied. One condition required the banking entity to incorporate the aggregate value of all ownership interests of a third-party covered fund in its aggregate 3% of tier 1 capital limit and capital deduction requirement.

Under the 2019 Final Rule, banking entities no longer are required to include the value of ownership interests in third-party covered funds held as underwriting or market-making positions for purposes of the 3% aggregate limit and capital deduction requirement. The agencies made this change to align more closely the requirements for underwriting or market-making in covered funds interests with the requirements for engaging in these activities with respect to other financial instruments and to mitigate compliance challenges with the 2013 Final Rule's exemption.

A third-party covered fund for this purpose is one that the banking entity does not sponsor, advise, or acquire or retain an ownership interest in pursuant to the asset management exemption or the asset-backed securities issuer exemption. Under the 2019 Final Rule, directly or indirectly guaranteeing, assuming, or otherwise insuring the obligations or performance of the covered fund (or any covered fund in which such fund invests) would no longer require the banking entity to treat the covered fund as a "related" (not third-party) covered fund for purposes of this exemption.

In response to comments, the agencies will continue to consider whether the approach adopted in the 2019 Final Rule for third-party covered funds should be extended to other covered funds, such as advised funds, and intend to address this issue in a future covered funds proposal. The agencies also will consider comments made regarding the treatment of parallel covered fund investments.

Under the 2019 Final Rule, banking entities are permitted to acquire or retain an ownership interest in a covered fund as a hedge when acting as an intermediary on behalf of a customer that is not itself a banking entity to facilitate exposure by the customer to the profits and losses of the covered fund. As a result, banking entities are permitted to hold covered fund interests to hedge fund-linked products.

PERMITTED RISK-MITIGATING HEDGING

The 2013 Final Rule permitted only hedging activities involving ownership interests in covered funds for hedging of certain employee compensation arrangements and did not include a broader hedging exemption to facilitate customer-facing activity. Under the 2019 Final Rule, banking entities are permitted to acquire or retain an ownership interest in a covered fund as a hedge when acting as an intermediary on behalf of a customer that is not itself a banking entity to facilitate exposure by the customer to the profits and losses of the covered fund. As a result, banking entities are permitted to hold covered fund interests to hedge fund-linked products.

In contrast to statements made when adopting the 2013 Final Rule, 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 (any activity that meets this standard should be permitted under the so-called prudential backstops). The agencies caution, however, that the exemption is meant only for customer-driven transactions. A banking entity cannot rely on this exemption to solicit customer transactions to facilitate the banking entity's own exposure to a covered fund.

The 2019 Final Rule also adopts the same amendments to align this exemption with the revised proprietary trading hedging exemption by eliminating the requirement that a risk-mitigating hedging transaction "demonstrably" reduce or otherwise significantly mitigate the relevant risks.

SOTUS EXEMPTION

Foreign banking entities benefit from an exemption to the covered funds prohibition for covered fund investments and sponsorship that occurs solely outside of the US. Just as for the TOTUS exemption, the 2019 Final Rule removes the condition that had prohibited a US branch or affiliate from providing financing for the foreign banking entity's ownership or sponsorship under the SOTUS exemption. The SOTUS exemption does not preclude a foreign banking entity from engaging a non-affiliated US investment adviser, as long as the actions and decisions of the banking entity as principal occur outside of the US.

The 2019 Final Rule also codifies the marketing restriction guidance of the agencies' Volcker Rule FAQ No. 13 (available at *federalreserve.gov*), which provides that the SOTUS exemption is available for investing in covered funds, as long as the foreign banking entity does not participate in the offer or sale of ownership interests to US residents. Consistent with FAQ No. 13, if the foreign banking entity sponsors or advises a covered fund, the foreign banking entity would be deemed to participate in any offer or sale of the covered fund ownership interests for purposes of this exemption.

SUPER 23A PRIME BROKERAGE EXEMPTION

The Volcker Rule includes the so-called Super 23A restriction, which prohibits "covered transactions" (as defined in Section 23A of the Federal Reserve Act) between a banking entity that sponsors, advises, or manages a covered fund (or any of such banking entity's affiliates) and the covered fund and any covered fund controlled by the first covered fund. The Super 23A provisions in the 2013 Final Rule included an exemption for certain prime brokerage transactions.

One of the conditions to this exemption is that the banking entity's CEO certify in writing annually that the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which the covered fund invests. The 2019 Final Rule codifies the agencies' Volcker Rule FAQ No. 18 (available at *federalreserve.gov*) by providing that a banking entity must provide the CEO certification annually no later than March 31 of each year.

Search Affiliate Transaction Restrictions for Banks for more on the restrictions and requirements governing transactions involving banks and their affiliates, including Section 23A covered transactions.