The Banking Law Journal

Established 1889

An A.S. Pratt™ PUBLICATION

JANUARY 2020

EDITOR'S NOTE: "BANKLESS" BANKING?
Steven A. Meyerowitz

ARE BANKS IRRELEVANT?
Timothy D. Naegele

VOLCKER RULE REVISIONS STREAMLINE AND CLARIFY PROPRIETARY TRADING AND COVERED FUND RESTRICTIONS AND COMPLIANCE OBLIGATIONS
Bruce C. Bennett, Jeremy Newell, Karen Solomon, and Cody Gaffney

SEC PROPOSES NEW RULES TO UPDATE STATISTICAL DISCLOSURES FOR BANKING REGISTRANTS
William C. Hermann and James A. Borrasso, Jr.

LexisNexis

THE BANKING LAW JOURNAL

VOLUME 137 NUMBER 1 January 2020

Editor's Note: "Bankless" Banking?
Steven A. Meyerowitz 1

Are Banks Irrelevant?
Timothy D. Naegele 3

Volcker Rule Revisions Streamline and Clarify Proprietary Trading and Covered Fund Restrictions and Compliance Obligations
Bruce C. Bennett, Jeremy Newell, Karen Solomon, and Cody Gaffney 29

SEC Proposes New Rules to Update Statistical Disclosures for Banking Registrants
William C. Hermann and James A. Borrasso, Jr. 47

LexisNexis®

QUESTIONS ABOUT THIS PUBLICATION?

For questions about the **Editorial Content** appearing in these volumes or reprint permission, please call:

Matthew T. Burke at .... (800) 252-9257
Email: .... matthew.t.burke@lexisnexis.com
Outside the United States and Canada, please call . . . . (973) 820-2000

For assistance with replacement pages, shipments, billing or other customer service matters, please call:

Customer Services Department at . . . . (800) 833-9844
Outside the United States and Canada, please call . . . . (518) 487-3385
Fax Number . . . . (800) 828-8341
Customer Service Website . . . . http://www.lexisnexis.com/custserv/

For information on other Matthew Bender publications, please call

Your account manager or . . . . (800) 223-1940
Outside the United States and Canada, please call . . . . (937) 247-0293

ISBN: 978-0-7698-7878-2 (print)
ISSN: 0005-5506 (Print)

Cite this publication as:

The Banking Law Journal (LexisNexis A.S. Pratt)

Because the section you are citing may be revised in a later release, you may wish to photocopy or print out the section for convenient future reference.

This publication is designed to provide authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

LexisNexis and the Knowledge Burst logo are registered trademarks of RELX Inc. Matthew Bender, the Matthew Bender Flame Design, and A.S. Pratt are registered trademarks of Matthew Bender Properties Inc.

Copyright © 2020 Matthew Bender & Company, Inc., a member of LexisNexis. All Rights Reserved.

No copyright is claimed by LexisNexis or Matthew Bender & Company, Inc., in the text of statutes, regulations, and excerpts from court opinions quoted within this work. Permission to copy material may be licensed for a fee from the Copyright Clearance Center, 222 Rosewood Drive, Danvers, Mass. 01923, telephone (978) 750-8400.

Editorial Office
230 Park Ave., 7th Floor, New York, NY 10169 (800) 543-6862
www.lexisnexis.com

(2020-Pub.4815)

Editor-in-Chief, Editor & Board of Editors

EDITOR-IN-CHIEF
Steven A. Meyerowitz
President, Meyerowitz Communications Inc.

EDITOR
Victoria Prussen Spears
Senior Vice President, Meyerowitz Communications Inc.

BOARD OF EDITORS
James F. Bauerle
Keevican Weiss Bauerle & Hirsch LLC

Barkley Clark
Partner, Stinson Leonard Street LLP

Michael J. Heller
Partner, Rivkin Radler LLP

Satish M. Kini
Partner, Debevoise & Plimpton LLP

Douglas Landy
Partner, Milbank, Tweed, Hadley & McCloy LLP

Paul L. Lee
Of Counsel, Debevoise & Plimpton LLP

Givonna St. Clair Long
Partner, Kelley Drye & Warren LLP

Timothy D. Naegele
Partner, Timothy D. Naegele & Associates

Stephen J. Newman
Partner, Stroock & Stroock & Lavan LLP

David Richardson
Partner, Dorsey & Whitney

Stephen T. Schreiner
Partner, Goodwin Procter LLP

Elizabeth C. Yen
Partner, Hudson Cook, LLP

THE BANKING LAW JOURNAL (ISBN 978-0-76987-878-2) (USPS 003-160) is published ten times a year by Matthew Bender & Company, Inc. Periodicals Postage Paid at Washington, D.C., and at additional mailing offices. Copyright 2020 Reed Elsevier Properties SA., used under license by Matthew Bender & Company, Inc. No part of this journal may be reproduced in any form—by microfilm, xerography, or otherwise—or incorporated into any information retrieval system without the written permission of the copyright owner. For customer support, please contact LexisNexis Matthew Bender, 1275 Broadway, Albany, NY 12204 or e-mail Customer.Support@lexisnexis.com. Direct any editorial inquiries and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., 26910 Grand Central Parkway, #18R, Floral Park, NY 11005, smeyerowitz@meyerowitzcommunications.com, 646.539.8300. Material for publication is welcomed—articles, decisions, or other items of interest to bankers, officers of financial institutions, and their attorneys. This publication is designed to be accurate and authoritative, but neither the publisher nor the authors are rendering legal, accounting, or other professional services in this publication. If legal or other expert advice is desired, retain the services of an appropriate professional. The articles and columns reflect only the present considerations and views of the authors and do not necessarily reflect those of the firms or organizations with which they are affiliated, any of the former or present clients of the authors or their firms or organizations, or the editors or publisher.

POSTMASTER: Send address changes to THE BANKING LAW JOURNAL LexisNexis Matthew Bender, 230 Park Ave, 7th Floor, New York, NY 10169.

POSTMASTER: Send address changes to THE BANKING LAW JOURNAL, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207.

Volcker Rule Revisions Streamline and Clarify Proprietary Trading and Covered Fund Restrictions and Compliance Obligations

Bruce C. Bennett, Jeremy Newell, Karen Solomon, and Cody Gaffney*

Five federal financial regulators recently approved a final rule that will significantly revise existing regulations implementing the Volcker Rule—a statutory provision that generally prohibits banking entities from engaging in proprietary trading or taking an ownership interest in, sponsoring, or having certain other relationships with hedge funds or private equity funds. The authors of this article explain the key takeaways for the rule, which represents the most significant modification to date of the original Volcker Rule regulations.

Five federal financial regulators—the Federal Deposit Insurance Corporation (the "FDIC"), the Board of Governors of the Federal Reserve System (the "Board"), the Office of the Comptroller of the Currency (the "OCC"), the Securities and Exchange Commission (the "SEC"), and the Commodity Futures Trading Commission (the "CFTC") (collectively, the "agencies")—recently approved a final rule (the "final rule")[1] that will significantly revise existing regulations implementing the Volcker Rule—a statutory provision that generally prohibits banking entities from engaging in proprietary trading or taking an ownership interest in, sponsoring, or having certain other relationships with hedge funds or private equity funds.

The final rule adopts with certain revisions the proposed rule that the agencies released for public comment in July 2018 (the "proposed rule").[2] The

* Bruce C. Bennett (bbennett@cov.com) is a partner at Covington & Burling LLP representing domestic and global financial institutions and other market participants on transactional and regulatory aspects of the global markets. Jeremy Newell (jnewell@cov.com) is a partner at the firm representing a wide range of domestic and foreign banks and other financial institutions on regulatory and public policy matters. Karen Solomon (ksolomon@cov.com) is senior of counsel at the firm advising clients on a broad range of financial services regulatory matters. Cody Gaffney (cgaffney@cov.com) is an associate in the firm's Financial Services and Tax practice groups.

[1] *See* Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 84 Fed. Reg. 61,974 (Nov. 14, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-11-14/pdf/2019-22695.pdf (the "final rule").

[2] *See* Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg.

final rule represents the most significant modification to date of the original Volcker Rule regulations (the "2013 rule").[3]

The final rule makes substantial changes to the regulatory framework's proprietary trading restrictions and compliance program requirements, particularly for banking entities that do not have significant trading assets and liabilities. These changes are intended to provide greater clarity and certainty about the activities that are prohibited and to improve the effective allocation of compliance resources. While the final rule also includes a limited number of changes to the regulatory framework's covered fund provisions, most covered funds-related issues were deferred for future consideration, with the agencies indicating that they intend to address those aspects in a separate, forthcoming proposed rulemaking. Key takeaways from the final rule are as follows, and described more fully below.

KEY TAKEAWAYS

Compliance Program Requirements and Metrics

- *Tailoring of compliance program requirements*. The final rule retains the proposed rule's three compliance tiers, but increases the threshold for "significant" trading activity (i.e., the highest compliance tier) from $10 billion to $20 billion in average gross trading assets and liabilities for each of the previous four quarters. In the case of a U.S. banking entity, trading assets and liabilities are measured on a worldwide consolidated basis; in the case of a foreign banking entity, trading assets and liabilities are based on the combined U.S. operations of the foreign banking entity. The final rule tailors a banking entity's compliance program requirements based on a banking entity's level of trading activity. While banking entities with significant trading assets and liabilities must develop a six-pillar compliance program and are subject to covered fund documentation and CEO attestation requirements, banking entities with moderate trading activity are eligible to use a simplified compliance program, and banking entities with limited trading assets and liabilities benefit from a presumption of compliance.
- *Reporting metrics*. The final rule significantly streamlines the metrics

33,432 (July 17, 2018), *available at* https://www.govinfo.gov/content/pkg/FR-2018-07-17/pdf/2018-13502.pdf.

[3] *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5,535 (Jan. 31, 2014), *available at* https://www.govinfo.gov/content/pkg/FR-2014-01-31/pdf/2013-31511.pdf#page=1. This regulation was released in December 2013, but was published one month later.

reporting requirements applicable to banking entities with significant trading activity. While the final rule adopts a limited number of new reporting metrics, it simplifies or eliminates many of the existing reporting metrics, and reduces the reporting frequency from monthly to quarterly.

Proprietary Trading Restrictions

- *Definition of* "*trading account.*" On the key definition of "trading account," the agencies chose not to adopt the proposed addition of an accounting prong, which was the focus of widespread commenter concerns. Instead, the final rule retains a modified version of the short-term trading intent prong, and replaces a presumption that financial instruments held for fewer than 60 days are for the trading account with a presumption that financial instruments held for more than 60 days do not meet the short-term intent prong. Importantly, the final rule also provides that a banking entity subject to the market risk capital prong of the trading account definition is not also subject to the short-term intent prong, and that banking entities not subject to the market risk capital prong may nevertheless elect to apply the market risk capital prong. These changes should substantially clarify and simplify compliance efforts in this area for banking entities subject to (or that elect to apply) the market risk capital rule prong.
- *Definition of* "*trading desk.*" The final rule adopts a multi-factor definition of "trading desk" that better aligns with the definition of "trading desk" used for other operational, management, and compliance purposes. In addition, banking entities subject to the market risk capital rules must use the same definition of "trading desk" used for market risk capital rule purposes.
- *Exclusions from the definition of* "*proprietary trading.*" The final rule adopts four new regulatory exclusions from the definition of "proprietary trading" that address trades to correct bona fide errors, customer-driven matched derivative transactions, hedges of mortgage servicing assets, and financial instruments that do not qualify as trading assets or liabilities. Additionally, the final rule expands the scope of the existing regulatory exclusion for liquidity management activities to include certain foreign exchange and cross-currency transactions.
- *Criteria for permitted underwriting and market making-related activities.* The final rule creates a presumption that banking entities satisfy the reasonably expected near-term demands ("RENTD") requirement of the statutory exemption for underwriting and market making-related

activities (that is, that such activities do not exceed the "reasonably expected near term demands" of customers) that is based on a banking entity's articulation and use of internal risk limits, subject to supervisory review, so as to provide a clearer way for banks and supervisors to determine if a trading desk's activities satisfy the RENTD requirement. The final rule also exempts banking entities that lack significant trading assets and liabilities from the specific compliance program requirements for underwriting and market making-related activities.

- *Criteria for permitted risk-mitigating hedging activities*. The final rule makes several targeted changes intended to streamline the framework for permitted risk-mitigating hedging activities, including the elimination of specific requirements to conduct correlation analyses. It also tailors the requirements of the risk-mitigating hedging exemption for banking entities that lack significant trading assets and liabilities.
- *Permitted trading activities of a foreign banking entity*. The final rule clarifies and simplifies the foreign trading exemption available to foreign banking entities by permitting some involvement by U.S. entities or personnel, and by eliminating existing requirements that (i) no financing for the transaction come from U.S. affiliates (the financing prong) and (ii) there be no U.S. counterparty to the transaction (the counterparty prong).

Covered Fund Activities and Investments

- *Deferral of any change to the definition of "covered fund."* The final rule does not include any change to the definition of "covered fund;" rather, the preamble to the final rule notes that the agencies intend to issue a future proposed rulemaking on fund-related issues (such as whether collateralized loan obligations ("CLOs") that own some debt securities are covered funds).
- *Removal of third-party covered funds from investment limits*. The final rule removes third-party covered funds (i.e., covered funds that the banking entity does not advise or organize and offer) from the aggregate fund-investment limit and capital deduction requirement.
- *Covered fund interests as a hedge*. The final rule permits a banking entity to own an interest in a covered fund as a hedge when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the customer's exposure to the covered fund.
- *Permitted covered fund activities of a foreign banking entity*. The final rule removes the financing prong from the eligibility criteria for the solely

outside of the United States ("SOTUS") exemption, and formally adopts existing guidance on the scope of the marketing restriction.

Other Issues

- *Deferral of any change to the definition of "banking entity."* The final rule does not create new exclusions from the definition of "banking entity" subject to the Volcker Rule, despite the fact that many commenters sought exclusions for various types of funds (e.g., registered investment companies, foreign public funds, and foreign excluded funds). However, the preamble to the final rule notes that the agencies intend to issue a future proposed rulemaking on fund-related issues.
- *Effective date and implementation*. The final rule will take effect January 1, 2020, but banking entities are not required to achieve compliance with the final rule until January 1, 2021. Nevertheless, banking entities may voluntarily comply with the final rule, in whole or in part, prior to the compliance date (subject to the completion of necessary technological upgrades by the agencies, which primarily relate to the acceptance of new reporting metrics as provided under the final rule).

BACKGROUND

The Dodd-Frank Act added new Section 13 to the Bank Holding Company Act of 1956, commonly known as the Volcker Rule.[4] The Volcker Rule contains two major prohibitions. First, the Volcker Rule generally prohibits a "banking entity" from engaging in proprietary trading. Second, the Volcker Rule generally prohibits a banking entity from acquiring or retaining an interest in or sponsoring a hedge fund or private equity fund (collectively, "covered funds"). "Banking entity" is defined by statute to include:

(i) An insured depository institution ("IDI"), as defined in the Federal Deposit Insurance Act;

(ii) Any company that controls an IDI;

(iii) Any company that is treated as a bank holding company under the International Banking Act of 1978; or

(iv) Any affiliate or subsidiary of an aforementioned entity.

The statute and existing regulations contain a number of highly technical and complex exclusions and exemptions to the proprietary trading and covered fund restrictions designed to permit banking entities to engage in activities

[4] *See* Pub. L. 111-203, tit. VI, § 619 (codified at 12 U.S.C. § 1851).

viewed as legitimate banking activities (e.g., underwriting and market making), or activities viewed as not undermining the safety and soundness of the banking entity and the U.S. financial system.

The Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (the "EGRRCPA") amended the Volcker Rule by exempting community banks, defined for that purpose as institutions that do not have, and are not controlled by companies that have, (i) more than $10 billion in total assets and (ii) total trading assets and liabilities that are more than five percent of total assets).[5] Additionally, the EGRRCPA relaxed certain restrictions on a banking entity sharing a name with a covered fund that it organizes and offers. The agencies finalized regulations implementing the EGRRCPA amendments to the Volcker Rule in July 2019.[6]

COMPLIANCE PROGRAM REQUIREMENTS AND METRICS

Tailoring of Compliance Program Requirements

In order to reduce compliance costs on banking entities with little or no trading activity, the proposed rule sought to tailor a banking entity's Volcker Rule compliance obligations based on the entity's average quarterly gross trading assets and liabilities over the previous four quarters.

The final rule substantially retains this tailored approach, with adjustments to the threshold amounts that establish the three compliance tiers. Under the final rule, a banking entity is classified as having "limited" trading assets and liabilities if its average trading assets and liabilities is less than $1 billion; a banking entity is classified as having "moderate" trading assets and liabilities if its average trading assets and liabilities is between $1 billion and $20 billion; and a banking entity is classified as having "significant" trading assets and liabilities if its average trading assets and liabilities exceeds $20 billion (an increase from the $10 billion threshold of the proposed rule). In the case of a U.S. banking entity, trading assets and liabilities are measured on a worldwide consolidated basis; in the case of a foreign banking entity, trading assets and liabilities are based on the combined U.S. operations of the foreign banking entity. Many of the final rule's elements are linked to the three compliance tiers, but the compliance tiers are most relevant for purposes of the compliance program requirements, discussed below.

---

[5] *See* Pub. L. 115-174, tit. II, § 203–04.

[6] *See* Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 84 Fed. Reg. 35,008 (July 22, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-07-22/pdf/2019-15019.pdf.

The final rule contains various clarifications of how a banking entity's level of trading activity is to be calculated. In particular, the final rule clarifies that foreign banking entities are classified by taking into account only the trading assets and liabilities of their combined U.S. operations. In addition, financial instruments that are obligations of or guaranteed by the United States (or a U.S. agency or government-sponsored enterprise) are not included in a banking entity's trading activity calculation. Finally, under the final rule, the agencies reserve the authority to require a banking entity to meet the requirements of a higher compliance tier (if warranted by the size and complexity of the banking entity's trading activities), provided that such determinations go through notice and response procedures established under the final rule.

The 2013 rule generally required banking entities to adopt a compliance program that incorporated six pillars enumerated in the regulation. In addition, the 2013 rule imposed additional compliance requirements (including covered fund documentation requirements and a CEO attestation requirement) on banking entities above a certain size and level of trading activity. The 2013 rule also provided for a simplified compliance program for small banking entities and banking entities that did not engage in extensive trading activity.

The final rule reworks the Volcker Rule compliance program requirements, tailoring those requirements to a banking entity's level of trading activity. Banking entities with significant trading assets and liabilities are subject to the six-pillar compliance program requirement, plus additional covered fund documentation and CEO attestation requirements. Banking entities with moderate trading activity are required to adopt a simplified compliance program. Banking entities with limited trading assets and liabilities benefit from a presumption of compliance, and are not required to demonstrate compliance. However, the appropriate agency may determine that a banking entity with limited trading assets and liabilities should be treated as having moderate trading assets and liabilities. In that situation, the agency will be required to adhere to certain notice and response procedures, which are also applicable to the other rebuttable presumptions under the final rule.[7]

Reporting Metrics

The 2013 rule required banking entities with trading activity above a certain threshold to furnish a large number of quantitative metrics—including position

---

[7] Under the notice and response procedures, the agency will provide a written explanation of its determination to the banking entity, which will then generally have 30 days to respond. Thereafter, the agency will notify the banking entity of its decision in writing. In addition to requiring a banking entity to comply with the requirements of a higher compliance tier, the notice and response procedures will apply to various rebuttable presumptions adopted in the final rule.

limits, risk factor sensitivities, value at risk, profit and loss attribution, inventory turnover and aging, and customer-facing trade ratios—to the appropriate agency in accordance with Appendix A of the 2013 rule. Banking entities were required to furnish such metrics on a monthly basis.

The final rule clarifies that the metric reporting requirements apply only to banking entities with significant trading assets and liabilities, and revises Appendix A to materially reduce compliance costs by eliminating, replacing, or streamlining various metrics required to be reported. The final rule additionally adopts new reporting metrics in a limited number of cases, including trading desk information and a narrative statement describing calculation methods and trading desk structure or strategies. Additionally, the final rule reduces the reporting frequency such that banking entities must submit metrics on a quarterly (rather than a monthly) basis. Taken together, the preamble to the final rule estimates that the revised metrics in the final rule will result in a 67 percent reduction in the number of data items and 94 percent reduction in the total volume of data required to be reported.

PROPRIETARY TRADING RESTRICTIONS

Definition of "Trading Account"

The Volcker Rule's proprietary trading restriction prohibits a banking entity from engaging as principal for the trading account of the banking entity in any transaction to purchase or sell a security, derivative, commodity future, or other financial instrument as defined by regulation. The 2013 rule definition of "trading account" consists of three disjunctive prongs—the short-term intent prong, the market risk capital prong, and the dealer prong. The final rule makes targeted changes to each of these three prongs, and effectively revises the framework so that either the short-term intent prong or the market risk capital prong will apply to any particular banking entity, but not both.

Short-Term Intent Prong and 60-Day Presumption

The short-term intent prong defines "trading account" as any account that a banking entity uses to purchase or sell financial instruments principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging positions resulting from such purchases or sales. The 2013 rule contained a rebuttable presumption that a financial instrument held for fewer than 60 days is for the banking entity's trading account under this prong.

The proposed rule sought comment on replacing the short-term intent prong of the "trading account" definition with a new accounting prong. The proposed accounting prong would have defined "trading account" to include any account

used by a banking entity to purchase or sell financial instruments such as derivatives, trading securities, and available-for-sale securities that are recorded at fair value on a recurring basis under applicable accounting standards. However, in response to commenters' concerns that the accounting prong was overly broad and would have scoped in many activities that the Volcker Rule was not intended to address, the final rule does not incorporate the proposed accounting prong. In addition, the final rule does not adopt a related, proposed presumption that activities of a trading desk of a banking entity captured by the accounting prong were in compliance with the prohibition on proprietary trading if the activities did not exceed a quantitative threshold.

Instead of adopting the accounting prong, the final rule allows banking entities not subject to the market risk capital prong to elect to define their trading account by reference to either the short-term intent prong or the market risk capital prong. The preamble notes that this flexible approach is appropriate because the two prongs capture similar activities, and the ability to elect between them should benefit banking entities with a lower level of trading activity. As a result, the only banking entities that will remain subject to the short-term intent prong are those that are not subject to, and do not elect to apply, the market risk capital prong.

In addition, the final rule eliminates the 60-day presumption of the 2013 rule, and instead establishes a new rebuttable presumption that financial instruments held for 60 days or more are not within the short-term intent prong.

Market Risk Capital Prong

The market risk capital prong defines "trading account" as the account that a banking entity or an affiliate uses to purchase or sell financial instruments that are both covered positions under the regulations implementing the Volcker Rule and trading positions under the market risk capital rule (or are hedges of other positions subject to the market risk capital rule), provided that the banking entity is an IDI, a bank holding company, or a savings and loan holding company that calculates risk-based capital ratios under the market risk capital rule.[8] The final rule does not significantly alter the market risk capital prong of the 2013 rule. However, as discussed above, the final rule heightens the importance of the market risk capital prong, because (i) any banking entity subject to the market risk capital rule will be subject to the market risk capital

[8] The market risk capital rule supplements the prudential regulators' risk-based capital rules by requiring any bank subject to the rules to adjust its risk-based capital ratios to reflect the market risk in its trading activities. *See, e.g.,* 12 C.F.R. Part 3, Appendix B.

prong (but not the short-term intent prong), and (ii) any other banking entity may elect to be subject to the market risk capital prong in lieu of the short-term intent prong that would otherwise apply. In addition, the final rule adopts a transition period applicable to banking entities that become subject to the market risk capital prong (other than by election); such a banking entity may continue to apply another prong for up to one year after it becomes subject to the market risk capital prong.

The proposed rule also would have revised the market risk capital prong to allow foreign banking organizations to take into account different home-country market risk frameworks. The final rule does not adopt this change.

Dealer Prong

The dealer prong defines "trading account" as the account that a banking entity uses to purchase or sell financial instruments for any purpose in the event that (i) the banking entity is licensed, registered, or required to be licensed or registered to engage in the business of a dealer, swap dealer, or security-based swap dealer, or (ii) the banking entity is engaged in the business of a dealer, swap dealer, or security-based swap dealer outside the United States. The proposed rule did not suggest, and the final rule does not adopt, any changes to the dealer prong. However, the preamble to the final rule reaffirms that the dealer prong applies only to the extent the financial instrument is purchased or sold in connection with the banking entity's activities as a dealer, swap dealer, or security-based swap dealer, and not to transactions in connection with activities that are not of the type that would trigger registration as such a dealer.

Definition of "Trading Desk"

Many of the Volcker Rule's proprietary trading restrictions are applied at the level of the trading desk. The 2013 rule defines "trading desk" to mean 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 its affiliate. To resolve confusion arising from banking entities that use alternative definitions of "trading desk" for purposes of internal risk management and regulatory capital requirements, the final rule adopts a multi-factor trading desk definition based on the same criteria used to establish trading desks for other operational, management, and compliance purposes, including revisions to the market risk capital rule that the agencies expect to undertake.

Exclusions from the Definition of "Proprietary Trading"

While the Volcker Rule generally prohibits a banking entity from engaging in proprietary trading, the 2013 rule contains several exclusions from the definition of "proprietary trading." The final rule modifies one existing

regulatory exclusion for certain liquidity management activities and establishes four new regulatory exclusions to the definition of "proprietary trading."[9]

Liquidity Management Exclusion

The 2013 rule excludes the purchase or sale of securities for the purpose of liquidity management from the definition of "proprietary trading." To qualify for the exclusion, the securities transactions must:

(i) Be conducted pursuant to a detailed liquidity management plan;

(ii) Be for the principal purpose of liquidity management and not for the purposes covered by the short-term intent prong of the trading account definition discussed above;

(iii) Involve certain highly liquid instruments that are not reasonably expected to give rise to appreciable profits or losses as the result of short-term price movements; and

(iv) Be limited in amount that is consistent with the banking entity's near-term funding needs.

In addition:

(v) The banking entity must incorporate the liquidity management plan into its compliance program; and

(vi) The plan must be consistent with supervisory requirements.

The final rule broadens the liquidity management exclusion to allow banking entities to purchase or sell three additional types of financial instruments—deliverable foreign exchange forwards, foreign exchange swaps, and cross-currency swaps (including both physically settled and nondeliverable cross-currency swaps)—for liquidity management purposes, subject to and in accordance with the six requirements of the exclusion.

Transactions to Correct Bona Fide Errors

The final rule establishes a new regulatory exclusion from the definition of "proprietary trading" that will permit banking entities to engage in transactions to correct trading errors, provided that (among other requirements) the correcting transactions are made through a separately managed trade error account monitored by personnel independent from the traders responsible for the erroneous trade. The preamble notes that, for example, the exclusion will

---

[9] The final rule does not adopt a provision of the proposed rule that would have allowed a banking entity's primary financial regulator to determine, on a case-by-case basis, that any purchase or sale of a financial instrument is or is not for the trading account (and therefore is or is not proprietary trading).

protect a banking entity that erroneously trades the wrong financial instrument when acting as a custodian, which then needs to trade as principal to dispose of the financial instrument.

Matched Derivative Transactions, Including Loan-Related Swaps

The final rule establishes a new regulatory exclusion from the definition of "proprietary trading" that will permit banking entities to enter into a customer-driven swap (or customer-driven security-based swap) and a matched swap (or security-based swap), provided that (i) the transactions are entered into contemporaneously, (ii) the banking entity retains minimal price risk, and (iii) the banking entity is not a registered dealer, swap dealer, or security-based swap dealer. The exclusion[10] is intended to cover loan-related swap transactions in which a banking entity enters into a swap with a customer in connection with customer's loan (e.g., a floating rate to fixed rate interest rate swap with a customer to whom the banking entity extended a floating-rate loan), and an offsetting swap with a third party.[11] In all cases, the transaction must be entered into for the customer's valid business purpose.

Hedges of Mortgage Servicing Rights or Assets

The final rule adopts a new regulatory exclusion from the definition of "proprietary trading" that will permit banking entities to hedge mortgage servicing rights or mortgage servicing assets pursuant to a documented hedging strategy. The exclusion is intended to clarify that hedging of mortgage servicing assets (which are excluded from the definition of "covered position" in the market risk capital rule) is not proprietary trading for banking entities that are subject to the short-term intent prong (or that elect to apply the market risk capital prong) of the trading account definition. The exclusion therefore creates parity between smaller banking entities not subject to the market risk capital rule and larger banking entities subject to the rule.

Financial Instruments That Are Not Trading Assets or Trading Liabilities

The final rule establishes a new regulatory exclusion from the definition of "proprietary trading" that will permit banking entities to purchase or sell any financial instrument that does not meet the definition of "trading asset" or "trading liability" under the banking entity's applicable reporting form.

---

[10] Covington recommended the exclusion in a comment letter submitted on behalf of several banks. *See* Covington & Burling LLP, Comment Letter, *Treatment of Loan-Related Swaps in Volcker Rule Proposal* (Oct. 17, 2018), *available at* https://www.regulations.gov/document?D=OCC-2018-0010-0055.

[11] Note, however, that the exclusion is not limited to loan-related swaps, as it also encompasses other matched derivatives that meet the relevant criteria.

According to the preamble, the trading asset and liability definitions used for reporting purposes incorporate substantially the same short-term trading standard as the short-term intent prong of the trading account definition. Thus, like the exclusion for hedges of mortgage servicing assets, the exclusion is meant to provide more certainty to banking entities subject to the short-term intent prong (or that elect to apply the market risk capital prong) of the trading account definition.

Criteria for Permitted Underwriting and Market Making-Related Activities

The Volcker Rule contains a statutory exemption from the prohibition on proprietary trading for the purchase, sale, acquisition, or disposition of securities, derivatives, commodity futures, or other financial instruments in connection with underwriting or market-making-related activities, to the extent such activities do not exceed the RENTD of customers. The 2013 rule's implementation of the underwriting and marketmaking exemption requires that banking entities satisfy numerous requirements in order to rely on the exemption, including internal compliance program requirements, and requirements related to the compensation arrangements of personnel performing the banking entity's underwriting or market-making activities. Most significantly, however, the 2013 rule requires that the amount and type of financial instruments in a trading desk's underwriting position or marketmaker inventory must be designed not to exceed RENTD (the "RENTD requirement"), and requires that reasonable efforts are made to sell or otherwise reduce the underwriting position or market-making inventory within a reasonable period.

The final rule streamlines the requirements that a banking entity must satisfy to rely on the underwriting or market-making exemption by establishing a presumption of compliance with the RENTD requirement. Specifically, a banking entity is presumed to meet the RENTD requirement if the banking entity has established and enforces internal limits for the relevant trading desk that are based on enumerated factors. In the context of market making, the preamble to the final rule notes that trading desks may not treat affiliated trading desks as customers for purposes of the RENTD requirement.

Under the final rule, the banking entity's internal limits are subject to ongoing supervisory review and oversight by the appropriate agency, and the banking entity must keep records of any breaches or increases of the internal limit, which must be made available to the appropriate agency upon request.[12]

---

[12] The proposed rule would have required that banking entities promptly report to the appropriate agency when internal limits were breached or increased.

Finally, the presumption may be rebutted by the appropriate agency based on the facts and circumstances.

In addition to the presumption of compliance, the final rule makes several other changes to the underwriting and market-making exemption. Most significantly, the 2013 rule's internal compliance program requirements are eliminated for banking entities that do not have significant trading assets and liabilities. Finally, the final rule makes clarifying changes to the internal compliance program requirement applicable to banking entities with significant trading assets and liabilities.

Criteria for Permitted Risk-Mitigating Hedging

The Volcker Rule also contains a statutory exemption from the prohibition on proprietary trading for risk-mitigating hedging activities that are designed to reduce the specific risks to the banking entity in connection with and related to individual or aggregate positions, contracts, or other holdings. The 2013 rule's implementation of the risk-mitigating hedging exemption requires that banking entities satisfy certain requirements in order to rely on the exemption, including documentation requirements, requirements related to personnel compensation, requirements related to internal compliance programs, and requirements related to the hedging activity itself.

As in the case of the underwriting or market making exemption, the final rule eliminates many of the 2013 rule's requirements (including the internal compliance program requirement and compensation requirement) for banking entities that do not have significant trading assets and liabilities, and replaces them with less burdensome requirements. With respect to banking entities with significant trading assets or liabilities, the final rule relaxes the documentation requirements applicable to certain ordinary-course hedging activity.

Other changes to the risk-mitigation hedging exemption include (i) with respect to the internal compliance program requirements, the elimination of the 2013 rule's requirement that banking entities conduct a correlation analysis to ensure that hedging activities may reasonably be expected to reduce or mitigate the risks being hedged, and (ii) with respect to the requirements regarding the hedging activity itself, the elimination of the requirement that the hedging activity is designed at inception to "demonstrably" reduce the risk to the banking entity.

Permitted Trading Activities of a Foreign Banking Entity

Finally, the Volcker Rule contains a statutory exemption from the prohibition on proprietary trading applicable to certain foreign banking entities that engage in proprietary trading solely outside of the United States (the "foreign trading exemption"). The 2013 rule places five main conditions on the availability of the foreign trading exemption:

(i) The banking entity that trades as principal is not located in the United States or organized under U.S. federal or state law;

(ii) The banking entity that makes the decision to trade as principal is not located in the United States or organized under U.S. federal or state law;

(iii) The trade is not accounted for as principal by any branch or affiliate that is located in the United States or organized under U.S. federal or state law;

(iv) No financing for the trade is provided by any branch or affiliate that is located in the United States or organized under U.S. federal or state law; and

(v) The trade is not conducted with or through any U.S. entity (with certain exceptions).

The final rule eliminates the fourth and fifth of these conditions, known as the financing prong and the counterparty prong. In addition, the final rule eliminates an element of the first condition, which requires that no personnel of the banking entity or its affiliate that arrange, negotiate, or execute the trade may be located in the United States. The effect of these changes is to focus the requirements for the foreign trading exemption on whether the banking entity that engages in or decides to engage in the trade as principal is located in the United States; some involvement by U.S. entities or personnel does not destroy the foreign trade exemption.

COVERED FUND ACTIVITIES AND INVESTMENTS

Deferral of Any Change to the Definition of "Covered Fund"

The Volcker Rule's covered fund restriction prohibits a banking entity from acquiring or retaining an interest in or sponsoring a hedge fund or a private equity fund (collectively referred to as "covered funds"). The preamble to the final rule notes that the agencies received numerous comments urging revisions to the definition of "covered fund" and exclusions therefrom—for example, the exclusion of CLOs that own some debt securities from the definition of "covered fund"—but the final rule does not adopt any changes to this definition. Rather, the preamble states that the agencies intend to address the covered fund provisions in future rulemakings. The preamble notes that future rulemakings may also address certain limitations on a banking entity's relationships with a covered fund, and restrictions on prime brokerage transactions.

Removal of Third-Party Covered Funds from Investment Limits

As discussed previously, the Volcker Rule provides a statutory exemption for a banking entity's underwriting or market making activities. The 2013 rule provides that banking entities are not prohibited from taking an interest in or sponsoring a covered fund in connection with underwriting or market making activities, provided three conditions are met: (i) the banking entity complies with the requirements of the underwriting or market making exemption (discussed above), (ii) the banking entity complies with the three percent aggregate fund-investment limit and capital deduction requirement, and (iii) the banking entity complies with per-fund investment limits for certain categories of covered funds.

The final rule removes from the aggregate fund-investment limit and capital deduction requirement certain covered funds, namely covered funds that the banking entity does not advise or organize and offer ("third-party covered funds"). According to the preamble, the intent of the change is to more closely align the requirements for engaging in underwriting or marketmaking activities with respect to covered funds with the requirements for engaging in those activities with respect to other financial instruments.

Covered Fund Interests as a Hedge

As discussed previously, the Volcker Rule provides a statutory exemption for a banking entity's risk-mitigation hedging activities designed to reduce the specific risks to the banking entity in connection with its holdings. The 2013 rule implemented this exemption narrowly in the context of covered funds, permitting only limited risk-mitigating hedging activities involving ownership interests in covered funds for hedging employee compensation arrangements.

The final rule permits banking entities to acquire or retain an ownership interest in a covered fund as a hedge when acting as 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. A similar provision was considered during the development of the 2013 rule, but was rejected. The preamble to the final rule emphasizes that a banking entity's reliance on this exemption must be customer-driven; the exemption cannot be used to solicit customer transactions in order to facilitate the banking entity's own exposure to a covered fund.

Additionally, the final rule makes other changes to conform with the changes to the proprietary trading exemption for risk-mitigating hedging, such as removing the requirement that a hedging transaction "demonstrably" reduces the relevant risks.

Permitted Covered Fund Activities of a Foreign Banking Entity

The Volcker Rule provides a statutory exemption for certain foreign banking entities that invest in or sponsor covered funds solely outside of the United States (the "SOTUS exemption"). The 2013 rule placed several conditions on the availability of the SOTUS exemption, which generally parallel those placed on the foreign trading exemption discussed above, with the exception of the counterparty prong. The final rule removes the financing prong from the SOTUS exemption criteria, in parity with the changes made in the context of the foreign trading exemption.

In addition, the final rule formally adopts existing informal guidance regarding the statutory restriction against offering or selling ownership interests in covered funds to U.S. residents (the "marketing restriction"). In particular, the final rule clarifies that the marketing restriction applies only to covered funds in which a foreign banking entity or any of its affiliates participate; foreign banking entities are permitted to invest in third-party covered funds so long as the foreign banking entity does not engage in the offering of ownership interests to U.S. residents.

OTHER ISSUES

Deferral of Any Change to the Definition of "Banking Entity"

The preamble to the final rule notes that the agencies received a large number of comments recommending further regulatory exclusions from the definition of "banking entity." In particular, many comments sought exclusions for various types of funds (e.g., registered investment companies, foreign public funds, and foreign excluded funds), which have already been the subject of policy statements and informal guidance from the agencies. Despite these comments, the agencies declined to amend the definition of "banking entity" in the final rule. However, the preamble notes that the agencies intend to issue a separate proposal to address the Volcker Rule's covered fund provisions and other fund-related issues.

Effective Date and Implementation

The final rule took effect January 1, 2020, but banking entities are not required to achieve compliance with the final rule until January 1, 2021. Nevertheless, banking entities may voluntarily comply, in whole or in part, with the final rule prior to the compliance date, subject to the completion of technological upgrades by the agencies (which are necessary to accept new reporting metrics under the final rule).

CONCLUSION

The final rule should meaningfully streamline and clarify the Volcker Rule's proprietary trading and covered fund restrictions and compliance obligations for banking entities of all sizes. Additionally, banking entities can look forward to additional fund-related rulemaking.