GIBSON DUNN

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DODD-FRANK 2.0: U.S. AGENCIES REVISE THE VOLCKER RULE ON PROPRIETARY TRADING

To Our Clients and Friends:

Since it was enacted in July 2010, the Dodd-Frank Act's Volcker Rule has challenged banks and their regulators alike. This is particularly the case with respect to its restrictions on proprietary trading. It has been one thing for former Federal Reserve Chairman Volcker to state that "you know it when you see it," quite another to formulate a regulation that accurately defines proprietary trading and implements a broad statutory directive across complex business operations.

On August 20, 2019, the Office of the Comptroller of the Currency and the Board of Directors of the Federal Deposit Insurance Corporation, Director Gruenberg dissenting, approved an expected rewrite of the regulation on proprietary trading, along with some minor amendments to the provisions governing private equity funds and hedge funds (Revised Rule). The preamble stated that a new proposal to revise the funds' provisions more broadly would be forthcoming. The other Agencies charged with implementing the Volcker Rule are expected to follow.

As with most of the revisions to Dodd-Frank since 2016, the revision – proposed in somewhat different form in June 2018 (2018 Proposal) – is a moderate approach that recalibrates the original regulation (Original Rule) and removes certain unworkable excesses. This "Volcker 2.0" approach also focuses more intelligently on risk than the Original Rule and is more faithful to the statutory text. At the same time, it still aligns with the most defensible reason for the Volcker Rule, maintaining the nature of banking institutions as customer-serving businesses. The result is a pruning of some of the excesses of the Original Rule, while leaving the regulation targeted at banks with the largest trading operations.

New Risk-Based Approach

The Revised Rule, like the 2018 Proposed Rule, applies the statutory provisions differently depending on the size of a banking entity's trading assets and liabilities. It adopts a three-tiered approach, under which compliance obligations under the Rule's market-making, underwriting, and risk-mitigating hedging exemptions, as well as overall compliance program requirements, differ based on the tier in which tier a banking entity finds itself.

Tier	Trading Assets/Liabilities[1]
Significant	$20 billion or more
Moderate	$1 billion to $20 billion
Limited	Less than $1 billion

For non-U.S. banks, the final rule looks to the bank's combined U.S. operations only, and not its worldwide operations, when determining in which tier to place the non-U.S. bank.

The tiering revision alone is a substantial improvement. The Original Rule deemed a banking entity worthy of heightened compliance obligations based on total asset size, and set that threshold at an irrationally low number – $50 billion. Being based on amounts of trading assets and liabilities, the new tiers align more closely to the risks posed. The Agencies raised the threshold of the "Significant" tier from $10 billion in the 2018 Proposal to $20 billion, but they declined to make changes to the other tiers.

In addition, under the Economic Growth, Regulatory Relief and Consumer Protection Act of 2018, a banking entity is completely exempt from the proprietary trading restrictions if:

- It has, and is not controlled by a banking entity that has, total consolidated assets of $10 billion or less; and
- It has total trading assets and liabilities of 5% or less of total assets.

New Definition of Proprietary Trading – Closer to the Statute

The Dodd-Frank Act defined "proprietary trading," as well as the associated term "trading account," very obscurely:

> "[P]roprietary trading" . . . means engaging as principal for the trading account of the banking entity . . . in any transaction to purchase or sell, or otherwise acquire of dispose of, [Volcker covered financial instruments].
>
> "[T]rading account" means any account used for acquiring or taking positions in [Volcker covered financial instruments] principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts [as determined by regulation].[2]

The interpretive issue under these definitions is the concept of the "trading account." This is not a recognized term under prior banking law, nor do banking institutions organize their operations around such accounts. For this reason, the Volcker Agencies originally took considerable leeway with the statutory text in expanding these definitions, with the result that most principal activity in covered financial instruments was brought within the trading prohibition, and then was required to find an exempted "permitted activity" like underwriting or market making to justify itself.

Specifically, the Original Rule had three tests for determining what was proprietary trading, and one presumption that was rebuttable in theory, but not in fact:

- Purpose Test: a purchase and sale is principally for the purpose of short-term resale, benefiting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging one or more such positions.

- Market-Risk Capital Test: the banking entity is subject to the market-risk capital rule and the financial instruments are both market-risk covered positions and trading positions (or hedges thereof).

- Status Test: the banking entity is licensed/registered as a dealer, swap dealer or security-based swap dealer, or the banking entity engages in any such business outside the U.S.; and the covered financial instrument is purchased and sold in connection with such activities.

- Rebuttable presumption that a short-term resale purpose exists if an instrument is held for fewer than 60 days, or its risk is substantially transferred within 60 days.

The Revised Rule, by contrast, has two principal tests that will bind most institutions subject to the Revised Rule – the Market-Risk Capital Test and the Status Test. The former has been slightly modified so as not to apply to a banking entity that is not consolidated with an affiliate that calculates risk-based capital ratios under the market risk capital rule for regulatory reporting purposes; the latter was substantively unchanged. The Purpose Test is retained for those institutions that are not required to calculate market-risk capital, and do not elect to do so for Volcker purposes. (Such an election must be for a banking entity and all its wholly-owned subsidiaries.) The Revised Rule also reverses the Original Rule's presumption so that, with respect to the Purpose Test, a position that is held for 60 days or more and where the risk is not substantially transferred within 60 days is presumed ***not*** to be proprietary trading.

This simplification of the Original Rule is welcome and is a more reasonable construction of the statute. First, the Purpose Test – which looked to a banking institution's intent in purchasing and selling a Volcker instrument – is in many cases duplicative of the Market-Risk Capital Test. It was also not unreasonably characterized by JPMorgan Chief Executive Officer Jamie Dimon as requiring "a lawyer and a psychiatrist" to analyze every trade. Second, the Volcker Agencies never had enough staff to engage with banks on rebutting the 60-day presumption – this avenue of compliance was thus effectively read out of the Original Rule. Finally, for reasons that were never persuasive, the Original Rule did not provide any indication of what period of time would suffice for a banking entity to have certainty that it was ***not*** proprietary trading.

Expanded Exclusions from Proprietary Trading

Certain purchase and sale transactions are wholly outside the Volcker Rule, some statutorily, some under the Original Rule. The Revised Rule expands the number of regulatory exclusions to include:

- Purchases and sales of foreign exchange swaps and forwards, and cross-currency swaps (including nondeliverable cross-currency swaps), under the Liquidity Management Plan exclusion.

- Purchases and sales to correct *bona fide* trade errors; unlike the 2018 Proposal, there is no requirement that instruments bought or sold in such transactions be transferred to a special "trading error" account.

- For banking entities that are ***not*** dealers, swap dealers or security-based swap dealers, matched swap transactions entered into in connection with customer-driven swaps, such as a back-to-back swap entered into at the same time as a fixed-to-floating interest rate swap with a customer.
- Hedges of mortgage servicing rights or assets in connection with a documented hedging strategy.
- Purchases and sales of instruments that are not "trading assets" or "trading liabilities" under regulatory reporting forms.

Revised Definition of "Trading Desk"

For purposes of the conditions to the permitted activities of market-making and underwriting, the Original Rule included a definition of "trading desk," the place where many of the conditions were measured. In keeping with interpreting the statute's restrictions broadly, the Original Rule defined the term 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."[3] This definition did not align with the manner in which banking entities generally organized their businesses for operational, management or compliance purposes.

The Revised Rule adopts a more flexible definition, which should align better with banks' organizational structures and result in fewer compliance costs:

- "A 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" that is either:
    - Structured to implement a well-defined business strategy, organized to ensure appropriate setting, monitoring, and review of the desk's limits, loss exposures and strategies, and characterized by a clearly defined unit that engages in coordinated trading activity with a unified approach to its key elements; operates subject to a common and calibrated set of risk metrics, risk levels and joint trading limits; submits compliance reports and other information as a unit for monitoring by management; and books its trades together; or
    - For a banking entity that calculates risk-based capital ratios under the market risk capital rule, or a consolidated affiliate for regulatory reporting purposes of such a banking entity, established by the banking entity or its affiliate for purposes of market risk capital calculations under the market risk capital rule.

Underwriting and Market-Making: RENTD Compliance Through Internal Limits

The Volcker statute distinguishes permitted underwriting and market-making activities from impermissible proprietary trading in that the former are "designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties" (RENTD).[4] The Original Rule required "demonstrable analysis" of complex and opaque conditions as a means of satisfying the RENTD requirement, and in so doing, imposed considerable compliance obligations on banking entities. In

addition, studies since the enactment of the Volcker Rule found that liquidity in certain financial markets had been constrained[5] – itself a cause of supervisory concern.

The Revised Rule seeks to reduce these obligations and increase market liquidity by permitting banking entities to make use of their own risk limits in showing compliance with the RENTD condition. It therefore contains a rebuttable presumption of compliance with the Rule if a banking entity has established and implements, maintains, and enforces ***internal limits for the relevant trading desk designed to not to exceed RENTD***. The relevant supervisor may rebut the presumption of compliance if it believes that a banking entity's trading desk is exceeding RENTD, after notice to the banking entity.

With respect to underwriting, the internal limits must address, based on the nature and amount of the trading desk's underwriting activities:

- the amount, types, and risk of its underwriting position;
- the level of exposures to relevant risk factors arising from its underwriting position;
- the period of time a security may be held; and
- the liquidity, maturity, and depth of the market for the relevant types of securities.

With respect to market making, the internal limits must address:

- the amount, types, and risks of the trading desk's market-maker positions;
- the amount, types, and risks of the products, instruments, and exposures 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 a financial instrument may be held; and
- the liquidity, maturity, and depth of the market for the relevant types of financial instruments.

These limits are not required to be approved in advance, but they are subject to supervisory review and oversight on an ongoing basis. Unlike the 2018 Proposal, the Revised Rule does not require banking entities to report limit breaches, but they must maintain and make available to their supervisors on request records regarding any limit that is exceeded and any temporary or permanent increase to a limit.

If a banking entity breaches or increases a limit, the presumption of compliance will continue to be available only if the banking entity takes action as promptly as possible after a breach to bring the trading desk into compliance, and follows established written authorization procedures regarding the breach or increase, including demonstrable analysis of the basis for any temporary or permanent increase to a trading desk's limit.

In addition, the Revised Rule eliminates the specific compliance program requirements for the underwriting and market-making exemptions for banking entities that do not have significant trading assets and liabilities.

Simplification of Hedging Permitted Activity; Risk-Tailored Compliance

Like underwriting and market making, risk-mitgating hedging is an activity permitted by the statute even if it involves a purchase and sale of an instrument in the short term. The Original Rule imposed substantial conditions on this activity, however, in an effort to guard against abuse. These original conditions imposed a significant compliance burden and were not easily monitored in practice. In particular, the requirements that the banking entity conduct a correlation analysis and continuously show that the hedge was demonstrably reducing or significantly mitigating identifiable risks was a significant challenge.

The Revised Rule simplifies the conditions to risk-mitigating hedging and gives banking entities more flexibility in demonstrating compliance. It removes the Original Rule's requirements that a banking entity undertake a correlation analysis and show that the hedge was demonstrably reducing or significantly mitigating identifiable risks. Instead, and more closely following the statute, the hedging must be "designed to reduce or otherwise significantly mitigate one or more specific, identifiable risks" being hedged and be "subject, as appropriate, to ongoing calibration" to ensure that the hedging does not become prohibited trading.

In addition, for banking entities that have only moderate trading activities (greater than $1 billion in trading assets/liabilities but less than $20 billion), the Revised Rule reduces the scope of the required compliance program. For such firms, the requirement for a separate internal compliance program for hedging has been eliminated, as well as certain specific requirements,[6] limits on compensation arrangements for persons performing risk-mitigating activities, and documentation requirements.

For banking entities that have significant trading activities, the Revised Rule moderates the Original Rule's requirement for maintaining additional documentation for hedges and hedging techniques not established by a trading desk's policies and procedures. The requirement does not apply to purchases and sales of financial instruments for hedging activities that are identified on a written list of financial instruments pre-approved by the banking entity that are commonly used by the trading desk for the specific types of hedging activity, if the banking entity complies with appropriate pre-approved limits for the trading desk when doing the hedging.

Relaxation of Trading Outside the United States (TOTUS) Requirements

Unlike many statutes, the Bank Holding Company Act of which the Volcker Rule is a part applies extraterritorially, subject to specific exemptions for non-U.S. banking organizations. The Revised Rule relaxes the conditions that the Original Rule applied to the permitted activity of a non-U.S. bank trading "outside the United States," the so-called TOTUS permitted activity. In so doing, the Revised Rule focuses more clearly on potential risks to the United States caused by TOTUS activity.

Under the new conditions, a trade qualifies for TOTUS if:

- the banking entity engaging as principal in the purchase or sale (including relevant personnel) is not located in the United States or organized under the laws of the United States or of any State;

- the banking entity (including relevant personnel) that makes the decision to purchase or sell as principal is not located in the United States or organized under the laws of the United States or of any State; and

- the purchase or sale, including any transaction arising from risk-mitigating hedging related to the instruments purchased or sold, is not accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State.

Unlike the Original Rule, the trade can be with a U.S. counterparty and financing for the trade can be provided by the U.S. offices of the non-U.S. banking entity. A non-U.S. banking entity may also use a non-affiliated U.S. investment adviser in the trade as long as the actions and decisions of the banking entity as principal occur outside of the United States.

Modest Revisions to Covered Fund Provisions

The Revised Rule makes only minor revisions to the Volcker funds restriction; the preamble states a new proposal on this subpart will be forthcoming. In particular, the thorny question of whether a foreign excluded fund should be exempted from the definition of "banking entity" is left for another day, with some indication that the Agencies may still believe this is a question for Congress.[7] The only amendments are the following:

- The Revised Rule removes the Original Rule's requirement that banking entities include for purposes of the aggregate fund limit and capital deduction the value of any ownership interests of a third-party covered fund (*i.e.,* covered funds that the banking entity does not advise or organize and offer) acquired or retained in accordance with the underwriting or market-making exemptions.

- The Revised Rule permits a banking entity 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 (as in a fund-linked note). The Original Rule's prohibition of such activities had no clear statutory basis.

- The Revised Rule removes the Original Rule's condition to the SOTUS fund exemption that no financing be provided by U.S. offices.

- The Revised Rule codifies the Agency staff interpretation that the SOTUS marketing restriction applies only to funds sponsored by – and not to third-party funds invested in – by non-U.S. banking entities.[8]

Tiered, Risk-Base Compliance Regime

Consistent with its approach to risk, the Revised Rule substantially modifies the required compliance regime for banking entities with moderate and limited trading assets and liabilities. Significantly, the CEO certification, which the Original Rule had required for banking entities with $50 billion or greater in total consolidated assets, is eliminated for all such banking entities. This in itself is significant regulatory relief. In addition, the six-pillar compliance regime of the Original Rule applies only to banking entities with significant trading assets and liabilities. Banking entities with only moderate trading assets and liabilities may include in their existing compliance policies and procedures appropriate references to the Volcker Rule and its implementing regulation, with adjustments as appropriate given the activities, size, scope, and complexity of the banking entity. Entities with limited trading assets and liabilities benefit from a rebuttable presumption of compliance with the Volcker Rule.

Effective Date

The Revised Rule will be effective on January 1, 2020. In order to give banking entities a sufficient amount of time to comply with the changes adopted, banking entities will not be required to comply with the Revised Rule until January 1, 2021. Because the Revised Rule relaxes the Original Rule's requirements, the Agencies are permitting banking entities to comply voluntarily, in whole or in part, with the Revised Rule prior to January 1, 2021, subject to the Agencies' completion of necessary technical changes, principally with respect to metrics reporting.[9]

Conclusion

Ultimately, the fundamental issue with the Volcker Rule is the statute Congress passed. In an effort to cover every activity that ***could be*** proprietary trading, while at the same time using opaque and imprecise language, Congress ensured a "hard slog" for both banking entities and their supervisors. The Original Rule compounded this problem by interpreting the statute to expand its reach in virtually all close cases. The Revised Rule appropriately takes a different approach, focusing on what is the overall purpose of Dodd-Frank: the reduction of risk to banking entities and the financial system more broadly. By streamlining overall requirements, and focusing most stringently on the banking entities with the largest trading portfolios, "Volcker 2.0" provides better guidance to banking entities and will be easier for regulators to enforce.

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[1] For purposes of these thresholds, the amount of trading assets and liabilities are calculated as the "average gross sum" of assets and liabilities on a trailing 4-quarter basis, and the following obligations are excluded: U.S. government- and U.S. government agency-issued and -guaranteed securities, and securities issued or guaranteed by certain government-sponsored enterprises.

[2] 12 U.S.C. §§ 1851(h)(4), (h)(6).

[3] 12 C.F.R. § 248.3(e)(13).

[4] 12 U.S.C. § 1851(d)(1)(B).

[5] *See, e.g.*, J. Bao, M. O'Hara & A. Zhou, "The Volcker Rule and Market-Making in Times of Stress," Finance and Economics Discussion Series 2016-102, Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2016.102, at 3 ("Our results show that bond liquidity deterioration around rating downgrades has worsened following the implementation of the Volcker Rule. We find such adverse effects whether we benchmark to the pre-crisis period or to the period just before the Volcker Rule was enacted, and we find that the relative deterioration in liquidity around these stress events is as high during the post-Volcker period as during the Financial Crisis. Given how badly liquidity deteriorated during the Financial Crisis, this finding suggests that the Volcker Rule may have serious consequences for corporate bond market functioning in stress times.").

[6] These requirements include the requirements that at inception, the hedging position not give rise to significant new or additional risk that is not hedged contemporaneously and that hedging activity be subject to continuous review, monitoring and management.

[7] Stating that "[c]ertain concerns raised by commenters may need to be addressed through amendments to section 13 of the BHC Act," the preamble notes how community banks were statutorily excluded from the definition of "banking entity" in 2018.

[8] The Revised Rule also clarifies that the SOTUS exemption does not preclude a non-U.S. banking entity from engaging a non-affiliated U.S. investment adviser as long as the actions and decisions of the banking entity to invest in a fund occur outside of the United States.

[9] In a formal acknowledgment of what Agency staff had previously unofficially stated, the Revised Rule relaxes the metrics that banking entities with significant trading assets and liabilities have to report.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work in the firm's Financial Institutions practice group, or the following:

Matthew L. Biben - New York (+1 212-351-6300, mbiben@gibsondunn.com)
Arthur S. Long - New York (+1 212-351-2426, along@gibsondunn.com)
Michael D. Bopp - Washington, D.C. (+1 202-955-8256, mbopp@gibsondunn.com)
Jeffrey L. Steiner - Washington, D.C. (+1 202-887-3632, jsteiner@gibsondunn.com)
James O. Springer - New York (+1 202-887-3516, jspringer@gibsondunn.com)

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