Client Alert | Financial Institutions Advisory / Regulatory & Compliance

Regulators Begin Volcker Rule Review, Signalling Potential for Needed Clarifications

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The Office of the Comptroller of the Currency ("OCC") has issued a notice and request for public input ("Request")[1] on potential revisions to the implementing regulations for the Volcker Rule. The OCC's action represents a preliminary step by the financial regulators in providing Volcker Rule relief.

The Request does not propose any specific changes to the existing Volcker Rule regulations; rather, it includes questions seeking public comment on various aspects of the regulations, as detailed below. Nonetheless, the OCC action appears to be an effort to pave the way for a rewrite or clarification of at least discrete sections of the current Volcker Rule regulations.

While the Volcker Rule regulations were issued jointly by five different federal regulators,[2] the Request comes solely from the OCC, which charters, regulates and supervises national banks and federal savings associations as well as federal branches and agencies of foreign banks. Any changes to the current Volcker Rule regulations would require joint action by the OCC with the other federal bank supervisory agencies—the FRB and the FDIC—in consultation and coordination with the SEC and the CFTC (collectively, the "Agencies"). In the Request, the OCC indicates its intention to use any information obtained as a result of the Request "to inform the drafting of a proposed rule," which suggests that comments from all banking entities, whether or not supervised by the OCC, are solicited.

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Given the cost and time dedicated to Volcker Rule compliance, banking entities are likely to welcome any prospective lessening of that burden. While the Request will most likely not be the last opportunity for banking entities to submit comments as to how the Volcker Rule regulations should be revised, the Request represents a useful opportunity for banking entities to express their concerns about specific Volcker Rule compliance difficulties or burdens and any other aspects of the Volcker Rule that hamper their trading, funds or other activities. Any banking entity seeking to comment on the Request must do so by September 21, 2017.

Basis of the Request

One of President Trump's first actions upon taking office was to issue an executive order establishing a set of seven core principles ("Core Principles") for regulating the US financial system.[3]

The executive order called upon the Treasury Secretary to report on whether existing financial laws and regulations promote or inhibit the Core Principles and his recommendations for actions to be taken to promote the Core Principles.

The Treasury Secretary responded with an initial report ("Treasury Report")[4] focusing on banks and credit unions, which, among other things, listed a set of recommendations for simplifying the Volcker Rule and the scope of its application. The Treasury Report's recommendations on the Volcker Rule include:

- Enacting legislation to exempt from the Volcker Rule banks with $10 billion or less in total assets and those of any size with less than $1 billion in trading assets and trading liabilities and whose trading assets and trading liabilities represent 10% or less of total assets.
- Improving regulatory coordination by ensuring that interpretive guidance and enforcement of the Volcker Rule by the Agencies are "consistent and coordinated."
- Clarifying the prohibition on proprietary trading by revising the definition of "trading account" and eliminating the rebuttable presumption that financial positions held for fewer than 60 days constitute proprietary trading, as well as assessing whether to recommend eliminating the short-term purpose test prong from the statutory definition.
- Providing increased flexibility for market-making activities by banking entities under the "reasonably expected near term demand" ("RENTD") limitation, including by (among other things) allowing banks greater leeway to anticipate changes in markets for illiquid securities and ensuring that banking entities appropriately hedge positions in over-the-counter derivatives, as well as evaluating whether Congress should provide banking entities with an opportunity to opt out of the RENTD framework for market-making activities if they adopt enhanced trader mandates or hedge all significant risks.
- Reducing the "unnecessarily burdensome" requirements of the risk mitigating hedging exemption by permitting banking entities to use their standard business practices to monitor and to mitigate material risks rather than maintaining ongoing calibration of a hedge over time to meet regulatory requirements.
- Applying the enhanced compliance program requirements only to banking entities with at least $10 billion in trading assets rather than $50 billion or more in total consolidated assets.
- Simplifying the covered fund restrictions by, among other things, (a) adopting a simpler definition of "covered fund" that is not based on a fund's status under the Investment Company Act of 1940 ("IC Act") and with appropriate additional exemptions and supporting legislation, (b) amending the "Super 23A" statutory provision to incorporate the exemptions in Section 23A of the Federal Reserve Act from the restrictions on affiliate transactions, (c) extending the permitted seeding period for sponsored funds from one year to three years, (d) permitting banking entities (other than banks and their holding companies) to share the same or similar name with a sponsored fund, and (e) exempting foreign funds owned or controlled by a foreign bank or a foreign affiliate of a US bank.
- Evaluating whether Congress should enact a statutory "off-ramp" to permit a banking entity that is sufficiently well-capitalized such that the risks posed by its proprietary trading are adequately mitigated by capital to opt out of the Volcker Rule altogether, subject to certain conditions.

The OCC cites the Treasury Report's recommendations regarding the Volcker Rule in its Request and notes that the OCC's objective in issuing the Request is to "gather additional, more specific information that could provide focused support for any reconsideration" of the Volcker Rule regulations that the Agencies may undertake and "contribute to the development of the bases for particular changes that may be proposed." The OCC expects that any recommendations provided in response to the Request need not be limited to the particular recommendations in the Treasury Report, but that any recommendations provided should be "consistent with the spirit of the Treasury Report."

Scope of the Request

In recognition that the term "Volcker Rule" is commonly used to refer to both the statutory provisions included in the Dodd-Frank Act and the implementing regulations adopted jointly by the Agencies, the OCC specifies in the Request that it is "not requesting comment on changes to the underlying Volcker statute" but rather only those changes that could be implemented through action at the regulatory level. The Request expressly asks commenters to provide input "within the contours" of the existing statutory structure. That is a reflection of the fact that only Congress has the authority to amend the Volcker Rule statutory provisions.

For example, the Agencies cannot change the statutory definition of "trading account" (focused on short-term purchases and sales), notwithstanding the Treasury Report's recommendation that the short-term purpose test prong of the definition be eliminated. While such a change requires Congressional action, the Agencies have authority to clarify the scope of that definition in the regulations. For instance, given that the rebuttable presumption that positions held for fewer than 60 days constitute proprietary trading was included in the regulations but is not in the statute, the Agencies could eliminate or amend that presumption. Similarly, it does not appear the Agencies can do much to change the statutory definitions of hedge fund and private equity fund as an issuer that would be an investment company under the IC Act but for sections 3(c)(1) or 3(c)(7), notwithstanding the Treasury Report recommendation that a fund's Volcker Rule status no longer be based on its status under the IC Act. The Agencies could, however, seek to clarify when a fund would be deemed to be relying on those IC Act exemptions.[5]

Particular Areas of Focus

The Request does not indicate any view of the OCC or the other Agencies as to the changes, if any, that should be made to the Volcker Rule regulations. The Request notes, however, that many banking entities find the regulations to be "overly complex and vague," making it difficult at times to distinguish if particular trading or fund activity is permitted or prohibited under the regulations. The OCC also acknowledges that banking entities have indicated that the Volcker Rule is overly broad, with the proprietary trading ban extending beyond its purpose of promoting safety and soundness and preventing taxpayer bailouts. In particular, the Request discusses restrictions imposed on essential financial functions that serve to spur economic growth, such as valid market-making, hedging and asset-liability management. The OCC similarly acknowledges that banking entities have indicated that the covered fund prohibition captures investment vehicles that facilitate lending activity and capital formation and are equivalent to traditional private equity or hedge funds.

The Request identifies the following topics as being of particular interest to the OCC for public comment. Additionally, the Request includes a list of specific questions for these topic areas, which are included as Appendix A to this client alert.

Scope of Entities Subject to the Volcker Rule. The OCC recognizes that the Volcker Rule definition of banking entity captures entities that may not pose a systemic risk concern or that do not engage in the types of activities that present the type of risk that the Volcker Rule was designed to restrict. It also recognizes that foreign subsidiaries of foreign banking entities (including foreign funds they control) are captured in the banking entity definition.[6] The Request seeks comment on how the banking entity definition can be refined to include exemptions for these entities and others in a manner consistent with the purposes of the Volcker Rule and the statutory definition of banking entity. The Agencies may find that difficult to do. For instance, while the Agencies recognize that treating foreign funds controlled by foreign banking entities as banking entities

themselves may be an unintended consequence, they note that congressional action may be needed to resolve this issue.

Proprietary Trading Prohibition. The Request notes that complying with the short-term trading prong of the trading account definition presents a significant compliance burden for banks. It further notes that the rebuttable presumption in the regulations that positions held for fewer than 60 days fall within this prong covers trades not intended to be covered by the proprietary trading prohibition. The Request seeks public comment as to whether the rebuttable presumption should be eliminated or how it could be changed, including whether a reverse presumption should be adopted to make clear that positions held for 60 days or more are not proprietary trading. The Request also asks for comment on how the requirements for permissible trading activities could be revised to make compliance less burdensome, as well as whether other types of trading activities should be permissible under the regulations.

Covered Fund Prohibition. The OCC recognizes that defining a covered fund by reference to the IC Act section 3(c)(1) and (7) exemptions may have resulted in capturing issuers that were not intended to be covered by the Volcker Rule. The Request asks for comment on whether replacing the IC Act reference with a definition focusing on characteristics specific to hedge funds or private equity funds, such as investment strategy, fee structure, etc., would yield a less burdensome alternative. Although the Agencies could add a definition of covered fund based on such characteristics in the regulations, it is unclear how the Agencies could eliminate the existing definitions of hedge fund and private equity fund in the statute. The Request also seeks comment on whether additional categories of transactions or relationships between banking entities and covered funds should be permitted under the Super 23A prohibition of the Volcker Rule.

Compliance Program and Metrics Reporting Requirements. The OCC acknowledges that smaller banking entities and those not engaged in significant levels of trading and fund activities have indicated that even the simplified compliance program available to smaller institutions under the current regulations presents a substantial compliance burden. The Request asks whether there are any categories of entities for which the compliance program requirements in the regulations should be reduced or eliminated. Finally, the Request seeks comment on the effectiveness of current metrics for measuring compliance and the ways in which technology-based systems used by banking entities could be incorporated into Volcker Rule compliance.

APPENDIX A –SPECIFIC QUESTIONS IN OCC REQUEST

A- Scope of Entities Subject to the Volcker Rule

1. What evidence is there that the scope of the final rule is too broad?
2. How could the final rule be revised to appropriately narrow its scope of application and reduce any unnecessary compliance burden? What criteria could be used to determine the types of entities or activities that should be excluded? Please provide supporting data or other appropriate information.
3. How would an exemption for the activities of these banking entities be consistent with the purposes of the Volcker Rule, and not compromise safety and soundness and financial stability? Please include supporting data or other appropriate information.
4. How could the rule provide a carve-out from the banking entity definition for certain controlled foreign excluded funds? How could the rule be tailored further to focus on activities with a US nexus?
5. Are there other issues related to the scope of the final rule's application that could be addressed by regulatory action?

B- Proprietary Trading Prohibition

1. What evidence is there that the proprietary trading prohibition has been effective or ineffective in limiting banking entities' risk-taking and reducing the likelihood of taxpayer bailouts? What evidence is there that the proprietary trading prohibition does or does not have a negative impact on market liquidity?
2. What type of objective factors could be used to define proprietary trading?
3. Should the rebuttable presumption provision be revised, whether by elimination, narrowing, or introduction of a reverse presumption that presumes activities are not proprietary trading? Are there activities for which rebuttal should not be available? Should rebuttal be available for specified categories of activity? Could the rebuttable presumption provision be implemented in a way that decreases the compliance burden for banking entities?
4. What additional activities, if any, should be permitted under the proprietary trading provisions? Please provide a description of the activity and discuss why it would be appropriate to permit the activity, including supporting data or other appropriate information.
5. How could the existing exclusions and exemptions from the proprietary trading prohibition—including the requirements for permissible market-making and risk mitigating hedging activities—be streamlined and simplified? For example, does the distinction between "market-maker inventory" and "financial exposure" help ensure that trading desks using the market-making exemption are providing liquidity or otherwise functioning as market makers?
6. How could additional guidance or adjusted implementation of the existing proprietary trading provisions help to distinguish more clearly between permissible and impermissible activities?
7. Are there any other issues related to the proprietary trading prohibition that should be addressed by regulatory action?

C- Covered Fund Prohibition

1. What evidence is there that the final rule has been effective or ineffective in limiting banking entity exposure to private equity funds and hedge funds? What evidence is there that the covered fund definition is too broad in practice?

2. Would replacing the current covered fund definition that references sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 with a definition that references characteristics of the fund, such as investment strategy, fee structure, etc., reduce the compliance burden associated with the covered fund provisions? If so, what specific characteristics could be used to narrow the covered fund definition? Does data or other appropriate information support the use of a characteristics-based approach to fund investments?

3. What types of additional activities and investments, if any, should be permitted or excluded under the covered funds provisions? Please provide a description of the activity or investment and discuss why it would be appropriate to permit the activity or investment, including supporting data or other appropriate information.

4. Is Section 14 of the final rule (the "Super 23A" provision) effective at limiting bank exposure to covered funds? Are there additional categories of transactions and relationships that should be permitted under this section?

5. How could additional guidance or adjusted implementation of the existing covered fund provisions help to distinguish more clearly between permissible and impermissible activities? For example, should the final rule be revised to clarify how the definition of "ownership interest" applies to securitizations?

6. Are there any other issues related to the covered funds prohibition that could be addressed by regulatory action?

D- Compliance Program, Metrics Reporting Requirements and Additional Issues

1. What evidence is there that the compliance program and metrics reporting requirements have facilitated banking entity compliance with the substantive provisions of the Volcker Rule? What evidence is there that the compliance program and metrics reporting requirements present a disproportionate or undue burden on banking entities?

2. How could the final rule be revised to reduce burden associated with the compliance program and reporting requirements? Responses should include supporting data or other appropriate information.

3. Are there categories of entities for which compliance program requirements should be reduced or eliminated? If so, please describe and include supporting data or other appropriate information.

4. How effective are the quantitative measurements currently required by the final rule? Are any of the measurements unnecessary to evaluate Volcker Rule compliance? Are there other measurements that would be more useful in evaluating Volcker Rule compliance?

5. How could additional guidance or adjusted implementation of the existing compliance program and metrics reporting provisions reduce the compliance burden? For example, should the rule permit banking entities to self-define their trading desks, subject to supervisory approval, so that banking entities report metrics on the most meaningful units of organization?

6. How could the final rule be revised to enable banking entities to incorporate technology-based systems when fulfilling their compliance obligations under the Volcker Rule? Could banking entities implement technology-based compliance systems that allow banking entities and regulators to more objectively evaluate compliance with the final rule? What are the advantages and disadvantages of using technology-based compliance systems when establishing and maintaining reasonably designed compliance programs?

7. What additional changes could be made to any other aspect of the final rule to provide additional clarity, remove unnecessary burden, or address any other issues?

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[1] OCC, Proprietary Trading and Certain Interests in and Relationships with Covered Funds (Volcker Rule); Request for Public Input, 82 Fed. Reg. 36692 (Aug 7, 2017).

[2] Technically, only four of the five agencies—the OCC, the Federal Reserve Board ("FRB"), the Federal Deposit Insurance Corporation ("FDIC") and the Securities and Exchange Commission ("SEC")—jointly issued the Volcker Rule regulations. 79 Fed. Reg. 5526 (Jan 31, 2014). The fifth agency, the Commodity Futures Trading Commission ("CFTC"), issued its own Volcker Rule regulation in tandem with the joint rule issued by the other agencies. 79 Fed. Reg. 5808 (Jan. 31, 2014).

[3] Presidential Executive Order on Core Principles for Regulating the United States Financial System (Feb. 3, 2017), available at https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-executive-order-core-principles-regulating-united-states

[4] Treasury Department, A Financial System That Creates Opportunities: Banks and Credit Unions (Jun. 2017), available at https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf

[5] For instance, the Agencies recently issued temporary guidance on the treatment of certain foreign funds, referred to as qualifying foreign excluded funds," which clarifies that such funds are not covered funds for purposes of the Volcker Rule. Agencies, Statement Regarding Treatment of Certain Foreign Funds under the Rule Implementing Section 13 of the Bank Holding Company Act (Jul. 21 2017), available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170721a1.pdf.

[6] As noted above, the Agencies have recognized that the treatment of foreign funds that are controlled by foreign banking entities as themselves being banking entities subject to the Volcker Rule may be an unintended consequence of the Volcker Rule. The Agencies have issued temporary guidance specifying that that the Agencies will not take any action against foreign banking entities that treat certain foreign funds that they control as not being banking entities for a one year period through July 21, 2018.