Banking and Finance Law Daily Wrap Up, TOP STORY—FDIC and OCC take first steps to tailor and revise Volcker Rule regulations, (Aug. 20, 2019)

Banking and Finance Law Daily Wrap Up

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Dubbed by some as "Volcker Rule 2.0", the five federal financial regulators have begun to approve a final rule that will tailor the provisions of their Volcker Rule regulations to provide greater clarity and certainty.

The Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency became the first two federal financial regulators to approve a final rule that amends their regulations that implement the provision of the Section 13 of the Bank Holding Company Act, commonly referred to as the Volcker Rule. The Federal Reserve Board, Commodity Futures Trading Commission, and Securities and Exchange Commission are expected to adopt the final rule as well.

The Volcker Rule generally prohibits banking entities from engaging in proprietary trading and from investing in, sponsoring, or having certain relationships with a hedge fund or private equity fund, referred to as a "covered fund." The agencies issued their implementing regulations in late 2013 (see *Banking and Finance Law Daily*, Dec. 13, 2013).

The agencies proposed changes to their Volcker Rule regulations in June 2018 with the aim of clarifying what activities are prohibited, focusing requirements on entities with large trading operations and simplifying regulatory requirements (see *Banking and Finance Law Daily*, June 6, 2018). The proposal garnered over 75 unique comments from banking entities and industry groups, public interest groups, and other organizations and individuals. In addition, the agencies received over 3,700 comments from individuals using a version of a short form letter to express opposition to the proposed rule.

The final rule focuses on the following areas: compliance program requirements and thresholds; proprietary trading; definition of "proprietary trading;" and proprietary trading exemptions.

Compliance programs. The final rule includes a three-tiered approach to tailoring the compliance program requirements based on the level of a banking entities trading assets and liabilities.

Banking entities with total consolidated trading assets and liabilities of at least $20 billion would be considered to have "significant" trading assets and liabilities. Banking entities with significant trading assets and liabilities would be subject to a six-pillar compliance program, annual CEO attestation, and metrics requirements.

The next tier includes banking entities with moderate trading assets and liabilities, that is total consolidated trading assets and liabilities between $1 billion and $20 billion. These banking entities with moderate trading assets and liabilities would be subject to a simplified compliance program. Finally, there are banking entities with total consolidated trading assets and liabilities of less than $1 billion. These banking entities are considered to have "limited" trading assets and liabilities and will be subject to a presumption of compliance.

The final rule also modifies the Volcker Rule's metrics collection requirements to, among other things, eliminate certain metrics and reduce the compliance burdens associated with the remaining metrics requirements. Metrics filers must submit metrics on a quarterly basis with a reporting schedule of 30 days after the end of each quarter.

Proprietary trading. Among the changes to the definition of "proprietary trading," the final rule retains a modified version of the short-term intent prong; eliminates the agencies' rebuttable presumption that financial instruments held for fewer than 60 days are within the short-term intent prong of the trading account; and add a rebuttable

presumption that financial instruments held for 60 days or longer are not within the short-term intent prong of the trading account.

The final rule also would provide that a banking entity that is subject to the market risk capital rule prong, which the final rule would retain in a manner substantially similar to the agencies' 2013 rule, would not also be subject to the short-term intent prong. Moreover, a banking entity that is not subject to the market risk capital rule prong could elect to apply the market risk capital rule prong, as an alternative to the short-term intent prong under certain conditions. Finally, the final rule revises the trading desk definition to provide for consistent treatment across different regulatory regimes, including the market risk capital rule.

Proprietary trading exclusions. The final rule also modifies the liquidity management exclusion from the definition of proprietary trading to permit banking entities to use a broader range of financial instruments to manage liquidity, and it would add new exclusions for error trades, certain customer-driven swaps, hedges of mortgage servicing rights, and purchases or sales of instruments that do not meet the definition of "trading assets and liabilities" under the applicable reporting form.

Proprietary trading exemptions. Regarding exemptions for underwriting and market making-related activities, the final rule adopts a presumption of compliance with the reasonably expected near-term demand requirement for trading within certain internal limits. However, instead of requiring banking entities to promptly report limit breaches or increases to the agencies, banking entities would be required to maintain and make available upon request records of any such breaches or increases and follow certain internal escalation and approval procedures in order to remain qualified for the presumption of compliance.

The final rule also addresses the activities of foreign banking entities outside of the United States.

Effective date and compliance. Once all five agencies adopt the final rule, it becomes effective on Jan. 1, 2020, with a compliance date of Jan. 1, 2021, so as to give banking entities sufficient time to comply with the regulatory changes. Banking entities may voluntarily comply, in whole or in part, with the amendments adopted in the final rule following the effective date and prior to the compliance date, including the metrics requirements in the appendix to the final rule, subject to the agencies' completion of certain technological programming necessary in order to accept metrics consistent with the final rule. The agencies would work with banking entities to test the revised metrics submission format and determine how and when banking entities can voluntarily comply with the final rule prior to the Jan. 1, 2021 compliance date.

Reaction and comments. FDIC Chairman Jelena McWilliams released a statement saying, "While we are making important fixes to the proprietary trading and compliance provisions of this rule today, there is more work to be done. Additional fine tuning is necessary on the restrictions associated with covered funds, and we plan to make such changes through a future rulemaking."

Regarding future rulemaking, the agencies intend to issue an additional notice of proposed rulemaking that would propose additional, specific changes to the restrictions on covered fund investments and activities and other issues related to the treatment of investment funds. These proposed changes will include revisions to limitations on relationships between a banking entity and a covered fund for purposes of Section 23A of the Federal Reserve Act.

On the other hand, FDIC board member Martin J. Gruenberg said, "The final rule before the FDIC Board today would effectively undo the Volcker Rule prohibition on proprietary trading by severely narrowing the scope of financial instruments subject to the Volcker Rule. It would thereby allow the largest, most systemically important banks and bank holding companies to engage in speculative proprietary trading funded with FDIC-insured deposits."

Prior to the FDIC's adoption of the final, Comptroller of the Currency Joseph Otting released a statement. He said, "After extensive comment and feedback through the rulemaking process, I am pleased to approve changes to the 'Volcker Rule' that simplify the rule in a common sense way that preserves the safety and soundness of the federal banking system and eliminates unintended negative consequences of the prior rule."

Leadership of the House Financial Service Committee and Senate Banking Committee also weighed in on the FDIC's and OCC's action.

House Financial Service Committee Chairwoman Maxine Waters (D-Calif) said, "I am deeply concerned by today's FDIC and OCC actions, and potential additional votes by other regulators, to weaken this critically important rule." She added, "The final rule published today would curtail prohibitions in a manner that Congress never intended and allow Wall Street megabanks to gamble with the same types of risky loan securitizations that turned toxic in 2008, at a time when these risky products are once again on the rise." Waters concluded, "I call on the FDIC, OCC, and other regulators to reconsider this senseless decision, especially given the significant changes made from the initial proposal, and take the time to give the public a full and fair chance to comment."

The Financial Service Committee's Ranking Member Patrick McHenry (R-NC) said, "I have long advocated for reasonable reform of the Volcker rule—a rule that former Chairman Volcker himself has referred to as being too complicated—and applaud today's decision by the federal financial regulators. This proposal maintains prohibitions on proprietary trading, but also ensures financial institutions have the ability to make markets. Today's vote by the FDIC is an important step toward simplifying and clarifying this rule."

The Ranking Member of the Senate Banking Committee, Sherrod Brown (D-Ohio) "blasted" the FDIC and OCC for "for giving another gift to Wall Street megabanks." Brown added, "As the threats from leveraged lending and global uncertainty increase, greedy Wall Street banks and Trump regulators are determined to put the financial system and working families in danger. Trump regulators continue to open a Pandora's box of risky trading and speculation at the expense of American taxpayers."

Finally, Rob Nichols, president and CEO of the American Bankers Association, released a statement. He said, "We appreciate the actions taken today by the FDIC and OCC, which have started the agencies' process of finalizing sensible reforms to the Volcker Rule that will help banks better serve their customers and the broader economy. These improvements will allow bank supervisors to focus on systemic risk, while providing the tailored and precise oversight that was the Volcker Rule's original purpose." Nichols added, "We also applaud regulators for dropping the proposed accounting test, which was overly broad and unworkable. The decision to instead make meaningful improvements to the 60-day rebuttable presumption is consistent with the agencies' focus on bright-line rules."

Companies: American Bankers Association

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