DATE: May 31, 2018

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision

SUBJECT: Notice of Proposed Rulemaking: Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

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Recommendation: Staff recommends that the FDIC Board approve the attached interagency Notice of Proposed Rulemaking ("NPR") to amend the regulations adopted in 2013 ("2013 final rule") implementing section 13 of the Bank Holding Company Act ("BHC Act"), as enacted by section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 13 of the BHC Act, generally referred to as the Volcker Rule, contains certain prohibitions and restrictions on the ability of banking entities, including FDIC-supervised institutions, to engage in proprietary trading, and restricts the ability of banking entities to hold certain investments in, and have certain relationships with, hedge funds and private equity funds (collectively, "covered funds").

The NPR seeks to maintain the Volcker Rule's prohibitions and restrictions while also: (1) providing banking entities with greater certainty about prohibited and permitted activities and investments; (2) improving supervision; and (3) minimizing the compliance burden for smaller banking entities that engage in limited trading activities.

If approved, the NPR will be issued jointly by the Federal Deposit Insurance Corporation ("FDIC"), the Board of Governors of the Federal Reserve System ("Board"), the Office of the

Concurrence:

Charles Yi
General Counsel

Comptroller of the Currency (“OCC”), the Securities and Exchange Commission (“SEC”), and the Commodity Futures Trading Commission (“CFTC”) (collectively, the “Agencies”). The Agencies would issue this NPR in the *Federal Register* with a 60-day public comment period.

I. <u>Introduction</u>

Section 13 of the BHC Act generally prohibits banking entities from engaging in proprietary trading for the purpose of purchasing and reselling financial instruments in the near term or otherwise with the intent to resell in order to profit from short-term price movements. In addition, Section 13 generally prohibits banking entities from acquiring or retaining an ownership interest in, or sponsoring, a covered fund. Authority for issuing regulations to implement Section 13 of the BHC Act rests with the FDIC, Board, OCC, SEC, and CFTC. The Agencies adopted the 2013 final rule in December 2013. The Agencies are proposing amendments to the 2013 final rule to provide banking entities with greater certainty about what activities are prohibited and to improve supervision and implementation of section 13 of the BHC Act, while reducing the overall complexity and burden associated with the 2013 final rule.

The Agencies note that the Economic Growth, Regulatory Relief, and Consumer Protection Act (the Act), which was enacted on May 24, 2018, amends section 13 of the BHC Act and exempts from the definition of banking entity an institution, “that does not have and is not controlled by a company that has— (1) more than $10,000,000,000 in total consolidated assets; and (2) total trading assets and trading liabilities, as reported on the most recent applicable regulatory filing filed by the institution, that are more than 5 percent of total consolidated assets.” In addition, the Act provides that a, “hedge fund or private equity fund may share the same name or a variation of the same name as a banking entity that is an investment adviser to the hedge fund or private equity fund, if— (1) such investment adviser is not an insured depository institution, a company that controls an insured depository institution, or a company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978; (2) such investment adviser does not share the same name or a variation of the same name as an insured depository institution, any company that controls an insured depository institution, or any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978; and (3) such name does not contain the word 'bank'." The amendments took effect upon enactment.

The Agencies plan to address these statutory amendments outside of this rulemaking process. Further, the specific regulatory amendments proposed herein would not be inconsistent with the recent statutory amendments to section 13 of the BHC Act.

The Agencies have had several years of experience implementing the 2013 final rule and believe that supervision and implementation of the 2013 final rule can be improved. Based on supervisory experience since the adoption of the 2013 final rule, the Agencies have identified opportunities for improving the 2013 final rule, including further tailoring its application based on the activities and risks of banking entities. The Agencies believe that the proposed amendments to the 2013 final rule would provide banking entities with greater certainty about what activities are prohibited, and promote a more effective allocation of compliance resources. The Agencies also believe the modifications proposed in the NPR would improve the Agencies' ability to efficiently examine and supervise a banking entity's compliance with section 13 of the BHC Act.

Notwithstanding the proposed changes to the 2013 final rule, there are certain statutory limitations to permitted proprietary trading and covered fund activities, which are incorporated in the 2013 final rule and have not been changed in the proposed rule. These statutory limitations provide that such permitted activities must not: (1) involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; (2) result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or (3) pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

II. Overview of Proposal

General Approach

The Agencies seek to address a number of targeted areas for potential revision in this NPR. First, the Agencies propose to tailor the application of the 2013 final rule based on a banking entity's risk profile and the size and scope of its trading activities. Second, the Agencies aim to further streamline compliance obligations for smaller and mid-sized banking entities without large trading operations. Based on experience gained since the adoption of the 2013 final rule, the Agencies acknowledge the costs and uncertainty faced by smaller and mid-size banking entities in complying with the 2013 final rule. Third, the Agencies seek to streamline and clarify certain definitions and requirements related to the proprietary trading prohibition and limitations on covered fund activities and investments. To this end, and where appropriate, the Agencies have incorporated into the NPR certain matters previously addressed through Agency staff responses to Frequently Asked Questions.

Additionally, the NPR would reduce recordkeeping and compliance program requirements for all banking entities, streamline metrics reporting, and expand tailoring to make the scale of compliance commensurate with a firm's size and risk profile. The NPR would also establish a presumption of compliance for banking entities with limited trading activities.

The proposed amendments would retain the 2013 final rule's organization into four subparts, and would retain a metrics appendix while removing the 2013 final rule's second appendix (Appendix B) regarding enhanced minimum standards for compliance programs. The NPR would request comment on its potential impact on banking entities and their activities, and would provide various estimates of its expected potential economic impact.

Scope of the NPR

To better tailor the application of the 2013 final rule, the NPR would establish three categories of banking entities based on trading activity and risk profile. The first category would include banking entities with "significant" trading assets and liabilities, defined as those banking entities that, together with their affiliates and subsidiaries, have trading assets and liabilities (excluding obligations of or guaranteed by the United States or any agency of the United States) equal to or exceeding $10 billion. These banking entities would be required to comply with the most extensive set of requirements under the rule.

The second category would include banking entities with moderate trading assets and liabilities, defined as those banking entities that do not have significant trading assets and liabilities or limited trading assets and liabilities. These banking entities, together with their affiliates and subsidiaries, would have trading assets and liabilities (excluding obligations of or guaranteed by the United States or any agency of the United States) of less than $10 billion, but above the threshold described below for banking entities with limited trading assets and liabilities. These banking entities would be subject to reduced compliance requirements and a more tailored approach in light of their significantly smaller and less complex trading activities.

The third category would include banking entities with limited trading assets and liabilities, defined as those banking entities that, together with their affiliates and subsidiaries on a worldwide basis, have trading assets and liabilities (excluding obligations of or guaranteed by the United States or any agency of the United States), of less than $1 billion. As noted above, this $1 billion threshold would be based on the worldwide trading assets and liabilities of a banking entity and all of its affiliates, and would be based on the average gross sum of trading assets and liabilities over four quarters, as measured as of the last day of each quarter. With respect to a foreign banking organization and its subsidiaries, the $1 billion threshold would be based on worldwide consolidated trading assets and liabilities.

The NPR would establish a presumption of compliance for all banking entities with limited trading assets and liabilities, under which these banking entities would have no obligation to demonstrate compliance with subparts B and C of the rule on an ongoing basis. If, however, upon examination or audit, the relevant Agency determines that the banking entity has engaged in prohibited proprietary trading or covered fund activities, such Agency may exercise its authority to rebut the presumption of compliance and require the banking entity to be subject to the compliance requirements applicable to a banking entity with significant or moderate trading assets and liabilities. The purpose of the presumption of compliance would be to further reduce compliance costs for banks that either do not engage in the types of activities subject to section 13 of the BHC Act or engage in such activities only on a limited scale.

Proprietary Trading Restrictions

Subpart B of the 2013 final rule implements the statutory prohibition on proprietary trading and various exemptions. Section 3 of the 2013 final rule contains the core prohibition on proprietary trading and defines a number of related terms. The NPR would make several changes to section 3 of the 2013 final rule. The NPR would revise the definition of “trading account” in order to clarify the trading positions included in that definition, which is key to the scope of the propriety trading prohibitions in the 2013 final rule.

Definition of Trading Account

The 2013 final rule’s definition of the term trading account includes three prongs. The first prong includes any account that is used by a banking entity to purchase or sell one or more financial instruments principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position (the short-term purpose prong). For purposes of the short-term purpose prong, the 2013 final rule contains a rebuttable presumption that the purchase or sale of a financial instrument by a banking entity is for the trading account of the banking entity if the banking entity holds the financial instrument for fewer than 60 days or substantially transfers the risk of the financial instrument within 60 days of purchase (or sale). The second prong covers trading positions that are both covered positions and trading positions for purposes of the Federal banking agencies' market risk capital rules, as well as hedges of covered positions (the market risk capital prong). The third prong covers any account used by a banking entity that is a securities dealer, swap dealer, or security-based swap dealer to acquire or take positions in connection with the activities that require the banking entity to be licensed or registered as a securities dealer, swap dealer, or security-based swap dealer (the dealer prong).

In practice, determining whether or not positions fall into the short-term purpose prong of the trading account definition can result in uncertainty and additional costs or delays. Some banking entities have indicated they find it difficult to interpret and implement this prong. The NPR would remove the short-term purpose prong from the definition of trading account, eliminate the associated rebuttable presumption, and modify certain of the 2013 final rule's exclusions from the definition of trading account.

The NPR would replace the short-term purpose prong with: (1) an accounting prong; and (2) a presumption of compliance with the proprietary trading prohibition for certain trading desks of a banking entity. Under the accounting prong, a financial instrument that is recorded at fair value on a recurring basis under applicable accounting standards would be deemed to be for the trading account of the banking entity. Instruments that would be included in the accounting prong include, but are not limited to, derivatives, trading securities, and available-for-sale securities.

Presumption of Compliance

The proposed presumption of compliance under the accounting prong would extend to trading desks that stay below a prescribed absolute profit and loss threshold. Under the NPR, each trading desk that purchases or sells financial instruments may calculate the net gain or loss on the trading desk's portfolio of financial instruments each business day, reflecting realized and unrealized gains and losses since the previous business day, based on the trading desk's fair value for such financial instruments.

If the sum of the absolute value of the trading desk's profit and loss for the preceding 90-calendar-day period is $25 million or less, the trading desk would presumptively be in compliance with the prohibition on proprietary trading. The banking entity would have no obligation to demonstrate that the trading desk's activity is permitted. If this calculation exceeds $25 million, the banking entity would have to demonstrate compliance with section 13 of the BHC Act and the implementing regulations, as described in more detail below. The Agencies propose to include a reservation of authority to address any trading positions that would be inappropriate for a presumption of compliance.

Proprietary Trading Exclusions and Exemptions

Section 3 of the 2013 final rule excludes from the definition of proprietary trading certain purchases and sales of financial instruments. The NPR would make several changes to these exclusions, including expanding the scope of financial instruments covered in the liquidity management exclusion, and excluding transactions undertaken to correct errors made in connection with customer-driven or other permissible transactions.

Section 4 of the 2013 final rule implements the statutory exemptions for underwriting and market making-related activities. The NPR would make several changes to this section to improve the efficient application of these exemptions. The NPR would establish a presumption that trading within internally set risk limits satisfies the requirement that permitted underwriting and market making-related activities be designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties ("RENTD").

The NPR would modify the 2013 final rule's implementation of the statutory exemption for permitted risk-mitigating hedging activities in section 5 of the 2013 final rule, by reducing restrictions on the activities that qualify as a permitted risk-mitigating hedging activity. For banking entities with significant trading assets and liabilities, the NPR would retain many of the 2013 final rule's requirements, including the requirement that the hedging activity be designed to reduce or otherwise mitigate one or more specific, identifiable risks. The NPR would eliminate the requirement that the hedging activity demonstrably reduces or otherwise significantly mitigates risk, reduce documentation requirements associated with risk-mitigating hedging transactions that are conducted by one trading desk to hedge positions at another desk with pre-approved types of instruments within pre-set hedging limits, and eliminate the 2013 final rule's correlation analysis requirement.

For banking entities with moderate or limited trading assets and liabilities, the NPR would remove all requirements under the 2013 final rule except the requirement that the hedging activity be: (1) designed to reduce or otherwise mitigate one or more specific, identifiable risks arising in connection with and related to one or more identified positions, contracts, or other holdings; and (2) is subject, as appropriate, to ongoing recalibration to ensure compliance with the exemption.

In addition, the NPR would remove certain requirements of section 6(e) of the 2013 final rule implementing the statutory exemption for trading by a foreign banking entity that occurs solely outside of the United States. Specifically, the NPR would modify the requirement that any personnel of the banking entity or its affiliate that arrange, negotiate, or execute a purchase or sale not be located in the United States, to reference only the relevant personnel engaged in the purchase or sale. In addition, the NPR would remove the requirements that: (1) no financing for the banking entity's purchase or sale be provided, directly or indirectly, 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; and (2) a transaction with a U.S. counterparty must be executed with the foreign operations of the U.S. entity or through an unaffiliated intermediary and anonymously on an exchange.

Covered Fund Activities and Investments

Subpart C of the 2013 final rule implements the statutory prohibition on directly or indirectly acquiring and retaining an ownership interest in, or having certain relationships with, a covered fund, as well as the various exemptions to the prohibition. Section 10 of the 2013 final rule defines the scope of the prohibition on the acquisition and retention of ownership interests in, and certain relationships with, a covered fund, and provides the definition of covered fund. The NPR would request comment on a number of potential modifications to this section.

Section 11(c) of the 2013 final rule outlines the requirements that apply when a banking entity engages in underwriting or market-making-related activities with respect to a covered fund. The proposed amendments to the 2013 final rule would modify these requirements to generally allow for the same type of activities (e.g., underwriting, market-making, and hedging) with respect to covered fund ownership interests as are allowed for other types of financial instruments. The proposed amendments also would change section 13(a) of the 2013 final rule to expand a banking entity's ability to engage in hedging activities involving an ownership interest in a covered fund.

Compliance Program Requirements

Subpart D of the 2013 final rule requires a banking entity engaged in covered trading activities or covered fund activities to develop and implement a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading activities and covered fund activities and investments.

The NPR would retain the provision in the 2013 final rule that a banking entity that does not engage in proprietary trading activities (other than trading in U.S. government or agency obligations, obligations of specified government-sponsored entities, and state and municipal obligations) or covered fund activities and investments must only establish a compliance program prior to becoming engaged in such activities or making such investments. To further enhance compliance efficiencies, the NPR would reduce compliance requirements for most banking entities and expand tailoring of the requirements based on the banking entity's trading activities.

Under the NPR, banking entities with significant trading assets and liabilities would be required to establish compliance programs commensurate with the size, scope, and complexity of their activities and business structure that meet six specific requirements already included in the rule ("six-pillar compliance program"). These requirements focus on (1) written policies and procedures reasonably designed to ensure compliance with the rule, including limits on underwriting and market making, (2) a system of internal controls, (3) clear accountability for compliance and review of limits, hedging, incentive compensation, and other matters, (4) independent testing and audits, (5) training, and (6) recordkeeping requirements. A banking entity would be permitted to integrate compliance programs meeting these requirements into its existing compliance regime.

Under the NPR, a banking entity with moderate trading assets and liabilities would be required to include in its existing compliance policies and procedures appropriate references to the requirements of section 13 of the BHC Act and the rule as appropriate given the activities, size, scope, and complexity of the banking entity.

The NPR would eliminate Appendix B of the rule, which specifies enhanced minimum standards for compliance programs of large banking entities and banking entities engaged in significant trading activities. As described above, the NPR would require that banking entities with significant trading assets and liabilities have the six-pillar compliance program.

The NPR would revise section 20 of the 2013 final rule to require that the CEO of banking entities with significant or moderate trading assets and liabilities annually attest in writing that the banking entity has in place processes to establish maintain, enforce, review, test and modify its compliance program.

The NPR would establish an ongoing presumption of compliance for banking entities with limited trading assets and liabilities, subject to the Agencies' reservation of authority to require a banking entity to conform its operations to comply or establish additional compliance program requirements.

Metrics Reporting Requirement

The NPR would streamline the metrics reporting and recordkeeping requirements of Appendix A of the 2013 final rule, which applies to banking entities with $10 billion or more in trading assets and liabilities. These changes to Appendix A would eliminate some metrics entirely (e.g., Customer-Facing Trade Ratio and Inventory Turnover), and add a new, limited set of other metrics (e.g., Positions metric). Various other revisions would be made, such as limiting the applicability of certain metrics only to market-making and underwriting trading desks.

Among other changes, the proposed amendments to Appendix A would:

- Limit the applicability of certain metrics to only market making and underwriting desks;
- Replace the Customer-Facing Trade Ratio with a new Transaction Volumes metric to more precisely cover types of trading desk transactions with counterparties;
- Replace Inventory Turnover with a new Positions metric, which measures the value of all securities and derivatives positions;
- Remove the requirement to separately report values that can be easily calculated from other quantitative measurements already reported;
- Streamline and make consistent value calculations for different product types, using both notional value and market value to facilitate better comparison of metrics across trading desks and banking entities;
- Eliminate inventory aging data for derivatives because aging, as applied to derivatives, does not appear to provide a meaningful indicator of potential impermissible trading activity or excessive risk-taking;
- Require banking entities to provide qualitative information specifying for each trading desk the types of financial instruments traded, the types of covered trading activity the desk conducts, and the legal entities into which the trading desk books trades;
- Require a Narrative Statement describing changes in calculation methods, trading desk structure, or trading desk strategies;

- Remove the requirement that banking entities establish and report limits on Stressed Value-at-Risk at the trading desk-level because trading desks do not typically use such limits to manage and control risk-taking; and
- Extend the time for reporting from 10 days to 20 days for banking entities with over $50 billion in trading assets and liabilities. The schedule for banking entities with less than $50 billion in trading assets and liabilities would remain unchanged.

Taken together, these changes are expected to reduce the compliance burden for banking entities and enhance the collection of appropriate data.

III. Applicability to FDIC-Supervised Institutions

As of December 31, 2017, there are six state non-member insured depository institutions that would be deemed to have significant trading assets and liabilities because together with their affiliates and subsidiaries they each have trading assets and liabilities that exceed $10 billion. Under the proposed amendments to the 2013 final rule, these banking entities would continue to be subject to metrics reporting requirements to the extent they are engaged in covered trading activity, and will be subject to CEO attestation requirements as well as the six-pillar compliance elements of section 20 of the 2013 final rule. However, these banking entities would no longer be subject to enhanced compliance program requirements of Appendix B of the 2013 final rule.

In addition, there are seven state non-member insured depository institutions that would be deemed to have moderate trading assets and liabilities. These banking entities would also be required to submit an annual CEO attestation and include in their existing compliance policies and procedures appropriate references to the requirements of the rule that are applicable to the scale and scope of their covered activities. Six of these banking entities are not required to provide a CEO attestation under the 2013 final rule but would be required to attest under the NPR.

The remaining state non-member insured depository institutions would be deemed to have limited trading assets and liabilities. These banking entities would qualify for the rebuttable presumption of compliance. Five of these entities are subject to Appendix B under the 2013 final rule.

IV. <u>Conclusion</u>

Staff recommends that the FDIC Board approve for publication in the *Federal Register* the attached NPR to amend the 2013 final rule. The NPR would provide for a 60-day public comment period.

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