DATE: August 20, 2019

MEMORANDUM TO: Board of Directors

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

SUBJECT: Final Rule: 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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Summary: Staff is presenting for the approval of the Federal Deposit Insurance Corporation ("FDIC") Board of Directors ("FDIC Board") a request to publish the attached interagency final rule ("final rule") to amend the regulations adopted in 2013 ("2013 rule") implementing section 13 of the Bank Holding Company Act ("BHC Act"), commonly referred to as the Volcker Rule. Section 13 generally restricts banking entities, including FDIC-supervised institutions, from engaging 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 final rule is intended to provide banking entities with further clarity regarding prohibited activities and to improve supervision and implementation of the Volcker Rule.

If approved, the final rule would be issued jointly by the FDIC, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (collectively, the "agencies"). The agencies would issue the final rule in the *Federal Register* with an effective date of January 1, 2020, and a compliance date of January 1, 2021.

Concur:

Nicholas J. Podsiadly
General Counsel

Recommendation: Staff is requesting that the FDIC Board approve the final rule and authorize its publication in the *Federal Register* with an effective date of January 1, 2020, and a compliance date of January 1, 2021. Under this final rule, a banking entity may voluntarily comply prior to January 1, 2021, in whole or in part, with these amendments to the 2013 rule.

I. Introduction

Section 13 of the BHC Act generally prohibits banking entities from engaging in proprietary trading, which section 13 generally defines as 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, or having certain relationships with, a covered fund. Authority for issuing regulations to implement section 13 of the BHC Act rests with the agencies. The agencies adopted the 2013 rule to implement section 13 of the BHC Act.

Based on their experience in implementing the 2013 rule, the agencies published a notice of proposed rulemaking ("NPR") on July 17, 2018, that proposed certain revisions to the 2013 rule. The NPR sought to provide greater clarity and certainty about what activities are prohibited under section 13 of the BHC Act and to improve the effective allocation of compliance resources where possible. The agencies received a wide range of comments and are recommending certain changes in the final rule, as discussed further below.

Since the issuance of the NPR, the agencies promulgated a final rule to amend the 2013 rule consistent with the Economic Growth, Regulatory Relief, and Consumer Protection Act

(“EGRRCPA final rule”). The EGRRCPA final rule excludes certain community banks from the definition of insured depository institution for purposes of section 13 of the BHC Act.[1]

II. Summary of the NPR

The agencies sought to address a number of targeted areas for potential revision in the NPR. First, the agencies proposed to tailor the application of the 2013 rule to make the scale of activity commensurate with a banking entity’s size and level of trading activity. In particular, the agencies proposed to establish three categories of banking entities: (1) those with significant trading assets and liabilities, (2) those with moderate trading assets and liabilities, and (3) those with limited trading assets and liabilities. The agencies also invited comments on whether certain definitions, including “banking entity” and “trading desk,” should be modified.

Second, the NPR proposed several changes to subpart B of the 2013 rule, which implements the statutory prohibition on proprietary trading and various statutory exemptions. The NPR proposed revisions to the trading account definition, including replacing the short-term intent prong of the trading account definition with a new third prong based on the accounting treatment of a position (“accounting prong”) and, with respect to trading activity subject only to the accounting prong, establishing a presumption of compliance with the prohibition on proprietary trading, based on the absolute value of a trading desk’s profit and loss. Under the NPR’s accounting prong, the trading account would have encompassed financial instruments recorded at fair value on a recurring basis under applicable accounting standards.

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[1] See 84 Fed. Reg. 35008 (July 22, 2019). The EGRRCPA final rule implements section 203 of EGRRCPA, which excludes from section 13 banking entities that have total consolidated assets equal to $10 billion or less and total trading assets and liabilities equal to five percent or less of total consolidated assets. The EGRRCPA final rule also implements section 204 of EGRRCPA, which permits a banking entity to share a name with a covered fund that the banking entity organizes and offers under certain circumstances.

In addition, the NPR would have modified several of the exemptions and exclusions from the prohibition on proprietary trading in subpart B to clarify how banking entities may qualify for those exemptions and exclusions, as well as to reduce associated compliance burden. For example, the NPR proposed revising the 2013 rule provisions related to exemptions for underwriting and market making activities, the exemption for risk-mitigating hedging activities, the exemption for trading by a foreign banking entity that occurs solely outside the United States, and the liquidity management exclusion. Further, the agencies proposed establishing an exclusion for transactions to correct trading errors.

The NPR also proposed certain modifications to subpart C of the 2013 rule, which prohibits, subject to certain exemptions, banking entities from directly or indirectly acquiring or retaining an ownership interest in, or having certain relationships with, a covered fund. For example, the NPR proposed to modify provisions of the 2013 rule related to the underwriting or market making of ownership interests in covered funds and the exemption for certain permitted covered fund activities and investments outside of the United States. The NPR also would have expanded a banking entity's ability to engage in hedging activities involving an ownership interest in a covered fund. In addition, the agencies requested comment regarding tailoring the definition of a covered fund, including potential additional exclusions, and revising the limitations on banking entities' relationships with covered funds.

To improve upon compliance inefficiencies, the agencies proposed tailoring the compliance requirements based on the new compliance tiers. The NPR would have applied a six-pillar compliance program and CEO attestation requirement to firms with significant trading assets and liabilities and eliminated the enhanced minimum standards for compliance programs in Appendix B of the 2013 rule, which applies to banking entities that have $50 billion or more

in total U.S. assets or that are required to report quantitative metrics under Appendix A of the 2013 rule. The NPR proposed to require firms with moderate trading assets and liabilities to adhere to a simplified compliance program, with a CEO attestation requirement, and proposed a presumption of compliance with the rule for firms with limited trading assets and liabilities. The NPR would have included a reservation of authority specifying that the agencies could impose additional requirements on banking entities with limited or moderate trading assets and liabilities if warranted. The NPR also would have revised the metrics reporting and recordkeeping requirements by, for example, applying those requirements based on a banking entity's size and level of trading activity, eliminating some metrics, and adding a limited set of new metrics to enhance compliance efficiencies. In addition, the agencies requested comment on whether some or all of the reported quantitative measurements should be made public.

III. Public Comments on the NPR

The agencies invited comment on all aspects of the NPR, including specific proposed revisions and questions posed by the agencies, and received 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 comments the agencies received from banking entities and financial services industry trade groups were generally supportive of the NPR, with the exception of the proposed accounting prong, and provided recommendations for further targeted changes. The agencies also received comments in opposition to the NPR from various organizations and individuals.

Based on comments received and for the reasons discussed below, the agencies are proposing to adopt a final rule that incorporates a number of modifications of the NPR. Furthermore, 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 under the regulations implementing section 13 of the BHC Act, including addressing the provisions in section 14 of the 2013 rule involving limitations on relationships between a banking entity and a covered fund for purposes of section 23A of the Federal Reserve Act.

IV. The Final Rule

A. Three-Tiered Compliance Approach: Significant, Moderate, and Limited Trading Assets and Liabilities

Similar to the NPR, the final rule includes a three-tiered approach to tailoring the compliance program requirements. Under the NPR, the first category would have included firms with "significant" trading assets and liabilities equal to or exceeding $10 billion in consolidated trading assets and liabilities. The second category would have included firms with "moderate" trading assets and liabilities, which would have included those banking entities that have consolidated trading assets and liabilities of $1 billion or more, but with less than $10 billion in consolidated trading assets and liabilities. The third category would have included firms with "limited" trading assets and liabilities, defined as those banking entities that have less than $1 billion in consolidated trading assets and liabilities. However, in response to comments, the final rule would modify the threshold for banking entities in the "significant" compliance category from $10 billion in consolidated trading assets and liabilities to $20 billion in consolidated trading assets and liabilities. The agencies believe that this approach would increase compliance efficiencies for all banking entities relative to the 2013 rule and the NPR, and would further reduce compliance costs for firms that have little or no proprietary trading activity. Further, with respect to the $20 billion threshold for banking entities with "significant" trading assets and

liabilities, the agencies estimate that banking entities classified as having significant trading assets and liabilities would hold approximately 93 percent of the trading assets and liabilities in the U.S. banking system. The agencies also estimate that banking entities with significant trading assets and liabilities and those with moderate trading assets and liabilities in combination would hold approximately 99 percent of the trading assets and liabilities in the U.S. banking system.

The final rule would also include modifications to the calculation of trading assets and liabilities for purposes of determining which compliance tier a banking entity falls into by excluding certain financial instruments that banking entities are permitted to trade without limit under section 13. Additionally, the final rule would align the methodologies for calculating the "limited" and "significant" compliance thresholds for banking organizations by basing both thresholds on the trading assets and liabilities of the firm's U.S. operations.

B. Proprietary Trading Restrictions

The final rule would include many of the NPR's proposed changes to the proprietary trading restrictions, with certain modifications based on comments the agencies received. In particular, the final rule would not include the proposed accounting prong in the trading account definition. Instead, the final rule would retain a modified version of the short-term intent prong and replace the 2013 rule's rebuttable presumption that financial instruments held for fewer than 60 days are within the short-term intent prong of the trading account with 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 2013 rule, would not also be subject to the short-term intent prong. In

addition, under the final rule, 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, including the consistent application of the market risk capital prong among a banking entity and all of its wholly owned subsidiaries.

Further, the final rule would revise the trading desk definition in a manner substantially similar to the definition included in the NPR, a change intended to provide more flexibility to banking entities to align the definition with other trading desk definitions used in existing or planned operational, management, and compliance functions. As modified by the final rule, the trading desk definition would provide for consistent treatment of desks across different regulatory regimes, including the market risk capital rule.

C. Proprietary Trading Exclusions

Consistent with the NPR, the final rule would modify 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 financial instruments that do not meet the definition of trading assets and liabilities under the applicable reporting form for a banking entity as of January 1, 2020.

D. Exemptions for Permitted Proprietary Trading

The final rule would include the NPR's proposed changes to the exemptions from the prohibitions in section 13 of the BHC Act for underwriting and market making-related activities, risk-mitigating hedging, and trading by foreign banking entities solely outside the United States. With respect to the exemptions for underwriting and market making-related activities, the final rule would adopt the NPR's 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 would include the proposed changes to the covered funds provisions for which specific rule text was proposed, including with respect to permitted underwriting and market making and risk-mitigating hedging with respect to a covered fund, as well as investment in or sponsorship of covered funds by foreign banking entities solely outside the United States, and the exemption for prime brokerage transactions.

E. Compliance Program Requirements

The final rule would adopt the NPR's proposed changes to eliminate the enhanced compliance requirements in Appendix B of the 2013 rule and tailor the compliance program requirements based on a banking entity's trading activity. However, the final rule would apply the CEO attestation requirement only to firms with significant trading assets and liabilities. Also, in response to comments, the final rule would include modifications to the metrics collection requirements to, among other things, eliminate certain metrics and reduce the compliance burdens associated with the remaining metrics requirements.

Under the final rule, metrics filers would submit metrics on a quarterly basis. In addition, the final rule would retain the reporting schedule of 30 days after the end of each quarter. Although the agencies would not include any changes related to public disclosure of the metrics in this final rule, the agencies would continue to consider whether some or all of the metrics should be publicly disclosed, taking into account the need to protect sensitive, confidential

information, as well as restrictions on the agencies relating to the disclosure of sensitive, confidential business and supervisory information on a firm-specific basis.

F. Interagency Coordination

Section 13(b)(2)(B)(ii) of the BHC Act directs the agencies to "consult and coordinate" in developing and issuing the implementing regulations "for the purpose of assuring, to the extent possible, that such regulations are comparable and provide for consistent application and implementation of the applicable provisions of section 13 of the BHC Act to avoid providing advantages or imposing disadvantages on the companies affected…" The NPR requested comment on interagency coordination and received numerous comments suggesting ways in which the agencies could more effectively coordinate Volcker Rule-related supervision, examinations, and enforcement. In the final rule, the agencies have endeavored to provide specificity and clarity in order to avoid conflicting interpretations or uncertainty. The final rule would also include notice and response procedures that would provide a greater degree of certainty about the process by which the agencies will make certain determinations under the final rule. The agencies believe that the particular changes proposed for adoption in the final rule are meaningfully simpler and streamlined compared to the 2013 rule.

G. Effective Date and Compliance Date

The final rule would be effective on January 1, 2020. In order to give banking entities sufficient time to comply with the changes adopted, the final rule would establish a compliance date of January 1, 2021. However, 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 January 1, 2021 compliance date.

V. **Applicability to FDIC-Supervised Institutions**

As of December 31, 2018, there are 3 FDIC-supervised institutions that would be deemed to have significant trading assets and liabilities because together with their affiliates and subsidiaries they have trading assets and liabilities that exceed $20 billion. Under the final rule, these banking entities would be subject to reduced metrics reporting requirements to the extent they are engaged in covered trading activity, and would be subject to a CEO attestation requirement as well as the six-pillar compliance elements of the final rule. However, these banking entities would no longer be subject to the enhanced compliance program requirements of Appendix B of the 2013 rule.

In addition, there are 9 FDIC-supervised institutions that would be deemed to have moderate trading assets and liabilities. These banking organizations would not be required to submit an annual CEO attestation but would need to include in their existing compliance policies and procedures appropriate references to the requirements of the rule that are appropriate to the scale and scope of their covered activities.

The remaining FDIC-supervised institutions that are not excluded from the prohibitions of section 13 of the BHC Act by the community bank exclusion of EGRRCPA would be deemed to have limited trading assets and liabilities and would qualify for the rebuttable presumption of compliance.

VI. **Conclusion**

Staff requests that the FDIC Board approve for publication in the *Federal Register* the attached interagency final rule to amend the 2013 rule.

Contacts

RMS/Capital Markets:	Bobby Bean, Associate Director (ext. 8-6705)
	Michael Spencer, Chief, Capital Markets Strategies (ext. 8-7041)
	Andrew Carayiannis, Senior Policy Analyst (ext. 8-6692)
	Brian Cox, Senior Policy Analyst (ext. 8-7007)
Legal:	Michael Phillips, Counsel (ext. 8-3581)
	Benjamin Klein, Counsel (ext. 8-7027)
	Annmarie Boyd, Counsel (ext. 8-3714)