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REVISIONS TO THE VOLCKER RULE

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On May 30 the Federal Reserve Board, along with OCC, FDIC, SEC, and CFTC jointly published proposed revisions to tailor and simplify the Volcker rule which generally prohibits banks from engaging in proprietary trading and owning and investing in hedge funds and private equity funds. This proposal[1] represents the "first effort"[2] by the agencies to implement comprehensive Volcker rule reform. The proposal itself is quite dense, clocking in at 372 pages (plus an additional 120+ pages of SEC economic analysis) and containing 342 questions covering nearly all facets of the rule.

For many observers, the Volcker rule is a poster child of good regulatory intentions gone awry. The intent was to prevent traders from gambling with insured depositor money; the result has been concern in the trading room of market making and risk management activities like hedging being labelled ex post as "proprietary trading." Prudent risk management requires firms to take a view, an ownership view on risks faced by the bank – and then to act on that view, for instance by taking on a hedge. This inability to cleanly separate benign and indeed desirable risk management from less benign and undesirable proprietary trading has been the core problem with implementing the original Volcker rule.

We believe the proposed revisions are a net positive for both banks and the agencies, and four themes stick out:

1. **Better aligns with the existing risk control practices of banks**: The revisions establish a presumption of compliance for activity that takes place within an established risk management framework (including limits) that has been created consistent with the rule. This clearly changes the trade-by-trade focus of the current rule and will allow firms to better manage risk on a portfolio basis within established constraints.
2. **Increases flexibility for hedging**: The revisions significantly roll back the level of analysis required to demonstrate hedge effectiveness. This will allow firms to increase engagement in markets and potentially improve liquidity by removing an existing disincentive to assume risk they could be prevented from managing.
3. **Replaces subjective criteria (e.g. intent) with objective criteria**: The revisions appear to attenuate – if not eliminate – the trade-by-trade intent focus of the existing rule and allow firms to engage in the exempt activities of market-making, hedging and underwriting with less concern of ex post investigation of violation for any single trade.
4. **Moves closer to an enforceable regulatory regime**: We believe the revisions will make the enforcement of the rules easier for agencies as the reliance upon a limit structure to establish compliance, the pre-approval of commonly used hedging instruments and the elimination of complex analyses for demonstrating hedge effectiveness are changes which, among others, bring better clarity to assessing compliance.

While we view many of the developments as a net positive, there are certain proposed revisions that will likely have a limiting effect on the proposal's practical impact. For example, the inclusion of CEO attestation for banks with "moderate" trading operations will ultimately prevent them from realizing the level of impact that is conceptually envisaged

1 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, joint proposal by the FRB, OCC, FDIC, SEC, CFTC

2 Opening Statement on the Volcker Rule Proposal by Vice Chairman for Supervision Randal K. Quarles

in the proposed revisions to streamline their compliance requirements. However, the inclusion of the CEO attestation is a critical component of the framework and has been cited by Fed Governor Lael Brainard as such [3], so we think it is unlikely to be removed from future proposals.

Finally, there are critical aspects of the rule for which we would have liked to see more concrete proposals, such as the definition of covered funds. We note, however, that the proposal seeks detailed feedback on this and many other aspects of the rule that didn't have specific revisions proposed. This is an opening bid in what is likely to be a lengthy rulemaking revision process, and the industry should take seriously the solicitation for comment to help shape the final rule in a way that allows the original intent to be practically realized.

A BRIEF BACKGROUND

The so-called Volcker rule was born out of the financial crisis and named after its conceptual architect, former Federal Reserve Chairman Paul Volcker. The Volcker rule, formally Section 13 of the Bank Holding Company Act of 1956, was established as part the Dodd-Frank Wall Street Reform and Consumer Protection Act. The final Volcker rule was published in December 2013 with full compliance expected by July 2015.

The rule's primary motivation is to prevent insured depository institutions from engaging in proprietary trading and from acquiring, retaining ownership interests in, or sponsoring hedge funds or private equity funds. To use Former Chairman Volcker's words, "Proprietary trading of financial instruments – essentially speculative in nature – engaged in primarily for the benefit of limited groups of highly paid employees and of stockholders does not justify the taxpayer subsidy implicit in routine access to Federal Reserve credit, deposit insurance or emergency support."[4]

WHY WAS THE IMPLEMENTATION SO CHALLENGING?

There are five agencies responsible for the oversight of Volcker Rule implementation: the Federal Reserve, FDIC, OCC, SEC, and CFTC. The key implementation challenge the agencies faced was to eliminate proprietary trading and investments in hedge funds and private equity funds while continuing to allow certain "permitted activities" that, while similar to proprietary trading activity in form, represent core banking functions, such as market making, hedging, underwriting, and transacting in US government securities [5]. Although eliminating dedicated proprietary trading desks and wholly bank owned hedge funds and private equity funds was a relatively simple task, differentiating between genuine market making and proprietary trading on customer-facing desks proved to be a much more challenging effort.

3 Statement on the Volcker Rule Proposal by Governor Lael Brainard

4 Volcker, P., Commentary on the Restrictions on Proprietary Trading by Insured Depositary Institutions (2012)

5 FSOC, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds (2011)

The motivation for reaching beyond dedicated proprietary trading desks stemmed from a general concern expressed by many that, without a robust set of rules, banks may shift the activities of dedicated proprietary desks into the customer facing sales and trading operations. As a consequence, the agencies adopted an implementation framework that included a significant compliance regime that was meant to leverage the existing risk management frameworks of banks to enforce the prohibition and established requirements for new metrics, analyses and reporting with the aim of ferreting out trades that may have been executed with proprietary intent. These new requirements have proven to be quite complex and burdensome to implement, demanding complex analytics, executive attestations and significant regulatory resources.

Critics claim that the current implementation overshoots the mark and harms important core banking services, such as market making, underwriting, lending, and investing in an effort to prevent any semblance of proprietary trading. These concerns of overshooting also extend to covered funds, where banks feel that the legal burden to prove a particular fund's categorization is too costly and cumbersome.

Recognition of the need to streamline and simplify the rule is not reserved for industry practitioners and the trade associations. According to Vice Chairman Quarles, simplifying and tailoring the Volcker rule is a goal that is shared among all five agencies and among policymakers at those agencies with many different backgrounds.[6]

THE TIME FOR CHANGE

The final rule has now been in place for more than four years which has allowed both industry practitioners and the agencies to identify opportunities for potential enhancement to streamline the rule and deliver a more practicable and effective enforcement regime. The overarching objective of the revisions is to simplify and tailor the Volcker rule in light of experience with the rule in practice.[7]

Key changes include:

1. Tailoring of requirements based on scale of trading operations
2. Elimination of intent and the rebuttal presumption
3. Proprietary trading exemptions aligned with risk management practices
4. Elimination of the "enhanced" compliance program requirements
5. Making transactions outside of the US easier for FBOs
6. Relaxation of metrics reporting requirements

These are not fundamental changes to the spirit of the rule prohibiting banking entities to directly or indirectly engage in proprietary trading. However, the proposed revisions are significant and designed to enhance the rule's compliance efficiency by reducing requirements for all banking entities (to varying extents) and tailoring the

6 Opening Statement on the Volcker Rule Proposal by Vice Chairman for Supervision Randal K. Quarles

7 Opening Statement on the Volcker Rule Proposal by Vice Chairman for Supervision Randal K. Quarles

remaining requirements to ensure that the compliance burden is in line with the scale and complexity of banks' trading operations.

The biggest beneficiaries of the proposed revisions from a compliance standpoint will be those banks with "limited" or "moderate" trading operations. Limited trading banks effectively have been removed from the Volcker radar and have no ongoing obligation to demonstrate compliance with rule requirements. Banks with moderate trading operations will see some benefit as they will no longer need to have stand-alone Volcker compliance programs and can integrate those efforts into the existing compliance regime with greater latitude on how to do so given the specific scale, scope, and complexity of the bank. Though, as noted earlier, this benefit may be dampened by the CEO attestation requirement.

Banks with "significant" trading activities, and there are about 18 of them, will potentially benefit on two key fronts: first, they will benefit from a modest reduction in the compliance requirements, namely the removal of the "enhanced" compliance program involving hundreds of specific requirements and a rationalization of the required reporting metrics. More fundamentally, these banks will benefit the most from the shift to a risk management based approach implemented through thoughtfully calibrated internal risk limits. In addition, the proposal opens the possibility of re-organizing Volcker desk structures to be more in line with how larger banks actually organize and operate their trading businesses.

KEY REVISIONS IN THE PROPOSAL

1. **Tailoring of Volcker requirements based on scale of trading operations**: Three categories will be created, as measured by trading assets and liabilities: Banks with significant trading (>$10bn), moderate trading ($1-10bn), and limited trading (<$1bn). This is in line with the recent trend to differentiate regulatory oversight based on firm size and complexity. The agencies anticipate that ~40 firms will be categorized as having either significant or moderate trading activity, and taken together, represent approximately 98% of trading assets and liabilities.

2. **Elimination of intent and the rebuttal presumption**: The revisions address two of the most widely criticized aspects of the proprietary trading portion of the rule. First, a new "accounting" prong replaces the "intent" prong in the trading account definition. Second, the revisions remove the 60-day rebuttal presumption which presumed that all positions held for less than 60 days were "trading" and therefore potentially proprietary trading. Under the proposed accounting prong, financial instruments recorded at fair value on a recurring basis will be classified as trading activity. This includes, but is not be limited to, derivatives, trading securities, and Available For Sale (AFS) securities.

   AFS securities were not previously captured but are now in scope due to the new accounting prong. While High Quality Liquid Asset (HQLA) and government securities are already exempt in the current rule, investment activity (e.g. corporate bonds) conducted in the AFS account is now included.

3. **Proprietary trading exemptions aligned with risk management practices**: There are several key changes proposed to the proprietary trading exemptions, most notably:

   a. Presumption of rule compliance for activity conducted within an established risk limit management framework
   b. Expansion of liquidity management exemptions
   c. Lessening of requirements for eligible hedge exemptions

   Perhaps the most notable revision in the proposal pertains to the move away from "trade-by-trade compliance" to a presumption of compliance for activity conducted within an established risk management framework, including limits informed by analysis of the reasonably expected near term demand (RENTD) of customers. The move away from "trade by trade" compliance towards a risk limit based framework for underwriting and market making exemptions should reduce the concern that individual trades may be found to be in violation of the rule due to some perceived evidence of proprietary intent by the trader after the fact. This psychological test has always been highly ambiguous and subjective – and created an atmosphere of concern that dealers could be accused ex-post of illegal intent while trading. While the original rule required both a lawyer and a psychiatrist sitting next to you determining your intent[8] – the new one may only require a lawyer, who is already present in the legal and compliance departments.

The removal of the 60-day rebuttal presumption and switch to a risk limit based implementation could potentially improve short-term liquidity for certain instruments, like corporate bonds, whose liquidity has suffered in the years since the financial crisis. These revisions, coupled with the relaxation of hedge exemption requirements (more on this below), should allow firms to confidently increase their engagement in markets, at least to an equilibrium level driven by other economic or regulatory factors.

The agencies are also seeking comment on whether the definition of "trading desk" should be revised. Under the current rule, trading desk is defined 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." This definition is a critical component of the Volcker framework as many of the requirements take place at this level, including establishing compliance with the underwriting and market-making provisions for RENTD and calculation and reporting of the various compliance metrics. A change that allows firms to use their existing business unit structures for Volcker compliance would likely be a material reduction in burden as it would more closely align the compliance regime with existing risk control practices.

The expansion of the liquidity management exemptions appears to broadly apply to all HQLA in securities form that firms have been stockpiling to comply with various liquidity requirements, such as the Liquidity Coverage Ratio (LCR) and resolution planning-based liquidity requirements. Another related change is the exemptions for deliverable foreign exchange forwards and swaps, and physically settled cross-currency swaps used for liquidity management purposes.

Lastly, the requirements for eligible hedging exemptions has been lightened as well. In the current implementation, the rule requires banks to show that hedges demonstrably reduce or mitigate specific risks. For significant trading firms, the revisions eliminate the requirement to demonstrate that hedging activity "reduces" or otherwise "significantly mitigates" risk. These changes address an unintended outcome of the current rule in which the burden to demonstrate hedge effectiveness reduced the assumption of risk – potentially impacting market liquidity.

8 Jaime Dimon, interview with CNBC (2012)

4. **Elimination of the "enhanced" compliance program requirements**: The proposal eliminates Appendix B of the current rule which requires large banking entities and banking entities engaged in significant trading activities to have a separate compliance program meeting certain enhanced minimum standards. The proposed rule would permit a banking entity with significant trading activities to integrate its compliance program meeting these requirements into its existing compliance regime. Note, however, that CEO attestation requirements will apply for firms with significant and moderate trading activity and is viewed by the agencies as a core component of the framework.
5. **Making transactions outside of the US easier for FBOs**: The proposed revisions intend to make the exemption that permits foreign banks to engage in proprietary trading outside the United States (the "TOTUS" exemption) more practical. The proposed revisions relax the requirement that prohibits personnel located in the United States from involvement in the transaction and remove the requirement that no financing be provided by an FBO's US entities.
6. **Relaxation of metrics reporting requirements**: There are several proposed changes to the metrics reporting requirements which generally aim to better align the effectiveness of the metrics data with its associated value in monitoring compliance. To that end, the proposal tailors the requirements based on a banking entity's size and level of trading activity and eliminates specific metrics that have proven to be of little value, while adding a limited set of new metrics.

THE PATH FORWARD

This is clearly just the beginning of what will likely be a lengthy process to revise the Volcker rule. There have been many criticisms of the current rule and its implementation. Some of these criticisms, such as the overwhelming compliance burden and the subjective "intent" prong for proprietary trading, have specific proposed revisions. Other areas of industry concern, such as the definition and treatment of covered funds, have more questions posed than concrete proposals made.

Importantly, the proposal seems to be a working draft rather than a fully baked set of proposals as evidenced by the more than 342 questions posed for public comment. We therefore think that the door is open for banks and other financial services firms to engage in the revised rulemaking process in a significant and meaningful way. We recommend that firms carefully review the proposal and assess the potential impact on the P&L dynamics of their businesses and the cost and resource implications for the supporting functions. Despite general regulatory and specific Volcker compliance fatigue, now is the time for banks to present reasoned arguments and pragmatic solutions supported by fact-based analysis to help inform the rulemaking process.

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