Volcker Rule: Observations on Interagency FAQs, OCC Interim Examination Guidelines

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More than six months after the release of final Volcker Rule regulations, banking organizations continue to grapple with a long list of interpretive questions and an opaque process for seeking clarity from the Volcker agencies. Regulatory silence broke for a brief moment this past week in the form of a short interagency **FAQ** and, from the OCC, **interim examination guidelines** for assessing banking entities' progress toward Volcker Rule compliance during the conformance period.

Neither document is a significant source of new guidance or interpretive gloss. Nonetheless, the OCC guidelines evidence the staff's intention to begin detailed inquiries into banks' conformance efforts to date and suggest a higher standard for interim compliance than many may have expected. It remains to be seen whether the other Volcker agencies take the same approach.

Prospects for clarification of a number of core interpretive questions in the near term remain remote. The FAQ and OCC guidelines do appear in a handful of notable instances, however, to confirm staff concurrence with views that have developed in the market in the months since adoption of the final regulations. Certain instructions to examiners in the OCC guidelines also suggest that the agency's staff has taken positions with respect to several open interpretive questions. The extent to which these views are consistent with those of other agency staffs is unknown.

In the bullets below, we highlight several clarifications and confirmations of note from the interagency FAQ and separately draw attention to a number of passages in the OCC guidelines that may be of interest. These bullets are not intended to summarize either document but instead to highlight points of interest for those that have been following Volcker Rule developments closely.

Interagency FAQ

- Proprietary Trading
  - *No new proprietary trading clarifications*. The FAQ restates a number of views provided informally by agencies and their staffs, or otherwise developed by the industry, over the past several months, including with respect to metrics reporting and the definition of "trading desk." It confirms that a banking entity must report the full set of metrics for a given trading desk to all agencies with jurisdiction over any entity into which that trading desk books trades.
- Covered Funds
  - *Capital deduction for permitted investments in covered funds*. The FAQ confirms that a banking entity is not required to deduct permitted investments in covered funds from tier 1 capital during the conformance period, currently scheduled to end on July 21, 2015. It does not address the interaction of the final regulations' capital deduction provisions with the banking agencies' 2013 Basel III rules, which the preamble to the final regulations indicates the banking agencies "expect to propose steps to reconcile."
  - *Loan securitization exclusion – scope of servicing assets*. The discussion of the loan securitization exclusion clarifies that an excluded loan securitization may hold servicing

assets of "any type," provided that a servicing asset that is a security must be a cash equivalent or received in lieu of a debt previously contracted consistent with the rule text.

- *Seeding of foreign public funds*. The FAQ clarifies that seeding vehicles for foreign public funds will be treated the same as seeding vehicles for registered investment companies (RICs) where applicable written plan and other requirements are met, confirming developing market consensus. Presumably, this identical treatment includes not being treated as violating the Volcker Rule's proprietary trading restrictions during the permitted seeding period. It requires that a written plan for a foreign public fund seeding vehicle specifically address the banking entity's "plan to operate the seeding vehicle in a manner consistent with the investment strategy, including leverage, of the issuer upon becoming a foreign public fund."
- *Name-sharing*. The FAQ grants no relief from the name-sharing prohibition in the asset management and securitization exemptions. It provides examples of features that would not comply with the name-sharing prohibition, including sharing "the same root word, initials or logo, trademark, or other corporate symbol that is also used by, or clearly references a connection with" the organizing and offering banking entity or an affiliate.

OCC Interim Examination Guidelines

- *Purpose and general insight.* As stated above, the guidelines indicate the OCC staff's view that banking entities must already have made demonstrable progress in preparing for the July 2015 general effective date of the Volcker Rule provisions. The introduction notes that the guidelines are intended to assist OCC examiners in assessing plans that banks "have developed" and "are implementing" to comply with the final regulations and suggests high staff expectations regarding banking entities' interpretation of the "good faith efforts" requirement in the Federal Reserve's December 10 conformance period order to develop and implement a conformance plan during the conformance period. Directions to examiners to assess progress appear frequently throughout the document.
- Conformance Planning and Implementation
  - *Objectives.* Examiners are provided with three objectives with respect to conformance planning and implementation:
    - assess the bank's progress toward identifying activities subject to the regulations;
    - assess the bank's progress toward establishing a compliance program; and
    - assess the bank's plan for avoiding material conflicts of interest and material exposures to high-risk assets and high-risk trading strategies.
  - *Emphasis on backstop provisions*. The guidelines place emphasis on the Volcker Rule "backstop provisions," which prohibit an otherwise permissible activity if it would involve or result in a material conflict of interest between a banking entity and its clients (subject to the ability to mitigate such conflicts through disclosure or information barriers), or results, directly or indirectly, in a material exposure to high-risk assets or high-risk trading strategies. To this point, these backstop provisions have likely been of secondary priority to banking entities; although the OCC guidelines provide no further substantive guidance on backstop compliance requirements, the evident focus on them suggests that additional effort and attention to these provisions may be necessary.
- Proprietary Trading
  - *Objectives*. Examiners are provided with six objectives with respect to proprietary trading:

    - assess the bank's progress toward reporting metrics as and when required;
    - assess the bank's progress toward using the metrics to monitor for impermissible proprietary trading;
    - assess the bank's progress toward identifying its market-making-related activities, market-maker inventory, and reasonably expected near-term demand (RENTD);
    - assess the bank's progress toward establishing a compliance program for permitted market-making-related activities;
    - assess the bank's progress toward establishing a compliance program for its underwriting activity; and
    - assess the bank's progress toward establishing a compliance program for its risk-mitigating hedging activity and satisfying the regulations' documentation requirements.
  - *Trading desk design*. The guidelines indicate the OCC staff's acceptance of the combination of existing trading desks into fewer Volcker Rule trading desks provided, among other requirements, that the combination has a "legitimate business purpose." The guidelines warn that such trading desk design could suggest that the bank is attempting to manipulate metrics. The guidelines note that the relevant factors for identifying a trading desk include whether the trading desk is managed and operated as an individual unit and whether the profit and loss of employees engaged in a particular activity is attributed at that level.
  - *Confirmation of client-by-client tagging for customer-facing metrics*. The metrics discussion confirms the industry's understanding that the agencies expect individual client-by-client tagging for the purposes of the customer-facing metrics. Ambiguity remains regarding whether banking entities can treat all counterparties with less than $50 billion of trading assets and liabilities as customers.
  - *Focus on RENTD and limits*. The guidelines place a heavy emphasis on the analysis and determination of RENTD, particularly in the context of the market-making exemption. Banking entities continue to struggle with the meaning and measurement of RENTD in the context of varying financial markets, as well as the ways in which to demonstrate an appropriate level of RENTD. As expected, the agencies also appear highly focused on the development of trading desk-specific limits as required for market-making and other exemptions.
- Covered Funds
  - *Objectives*. Examiners are provided with six objectives with respect to covered funds:
    - assess the bank's plan for conforming asset management and sponsorship activities;
    - assess the bank's plan for conforming securitization activities involving a securitization vehicle that is a covered fund;
    - assess the bank's plan for conforming underwriting and market-making activities in covered funds;
    - assess the bank's progress in ensuring compliance with the *de minimis* ownership limits on investments in covered funds relevant to the permitted asset management, securitization, underwriting, and market-making activities;

- assess the bank's plan for conforming hedging activities using covered funds; and
- assess the bank's plan for divesting nonconforming investments in covered funds.

o *Identification of advised covered funds.* Examiners are directed to assess a bank's progress toward identifying covered funds that the bank "advises" in addition to those it sponsors. This may simply be consistent with the requirement in the enhanced compliance program provisions of Appendix B to monitor for and prevent prohibited covered transactions with advised covered funds, among others, although neither the final regulations nor Appendix B includes a stand-alone requirement to identify or document advised covered funds.

o *Documentation of reliance on certain exclusions from the definition of covered fund*. The guidelines indicate that a banking entity that sponsors a fund that is not a covered fund by virtue of relying on one of the exclusions set forth in in § __.20(e)(2) — *i.e.*, foreign public funds, foreign pension or retirement funds, loan securitizations, ABCP conduits, covered bonds, and seeding vehicles for a RIC or an SEC-regulated business development company — must document "why it satisfies the terms of the exclusion." In context, this suggests that a more robust degree of detail is required with respect to justifying reliance on these exclusions than on other exclusions, *e.g.*, exclusions under the 1940 Act other than 3(c)(1) or 3(c)(7). The guidelines state that a banking entity need document only "why the fund is not a covered fund" with respect to the latter group.

o *Covered transactions*. In directing examiners to assess a bank's plan for identifying transactions with related covered funds that are subject to Super 23A, the guidelines refer to a "bank's plan for unwinding *covered transactions* between the bank" and related covered funds. The guidelines provide no further guidance with respect to the scope of covered transactions contemplated here, including on what basis the OCC staff has determined pre-existing covered transactions to violate the statute's prohibition on "enter[ing] into" such covered transactions.

o *Impermissible employee investments*. Examiners are directed to assess a bank's plan for "redeeming" employee investments that are impermissible under the employee investment condition of the asset management and securitization exemptions. Applications to the Federal Reserve for extensions of the conformance period with respect to such investments to enable orderly transfers to third parties, among other potential remedies, are presumably also contemplated.

o *Attribution of holdings of certain funds to a banking entity*. In instructing examiners to assess a bank's progress toward developing the capability to test quarterly for compliance with the 3% *de minimis* investment limits, the guidelines note that "mutual funds, business development companies, and *covered funds* are not deemed affiliates in this context if, among other things, the bank does not own, control, or hold with the power to vote 25 percent or more of the voting shares of the company or the fund." (Emphasis in original.) This suggests that, in the OCC staff's view, the exclusion of covered funds from the definition of "banking entity" is effectively superseded for purposes of the 3% attribution rules where a banking entity's investment in and relationships with a covered fund do not satisfy some version of the modified control standard for RICs, as set forth in the rule text and preamble.

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