

Volcker Rule 2019 Final Amendments: Summary and Proprietary Trading Flowcharts

September 11, 2019



Introduction

- The FDIC and OCC have approved final amendments to the original Volcker Rule regulations, which were first adopted by the CFTC, Federal Reserve, FDIC, OCC and SEC (the **Agencies**) in December 2013 (**2013 Rule**).
- The Federal Reserve, SEC and CFTC are expected to approve these same amendments in the coming days (**2019 Final Amendments**).
- The following slides first discuss the background to the 2019 Final Amendments and the key changes they make to the 2013 Rule.
- We then provide updated proprietary trading flowcharts, which graphically summarize the proprietary trading portion of the Volcker Rule regulations, as amended by the 2019 Final Amendments (the **2019 Amended Regulations** or **Volcker 2.0 – Prop**).
 - These updated flowcharts also reflect changes made to the Volcker Rule statute and regulations by the [Economy Growth Regulatory Relief & Consumer Protection Act](#) and implementing regulations in 2018 and 2019.

Background: The 2018 Proposal

- In May 2018, the Agencies proposed amendments to the 2013 Rule (**2018 Proposal**).
- The 2018 Proposal included a number of concrete proposed changes to the proprietary trading, compliance and metrics provisions of the 2013 Rule.
- Most significantly, the 2018 Proposal would have revised the **trading account** definition, which defines the scope of the proprietary trading provisions of the Volcker Rule.
 - The 2018 Proposal would have replaced the **short-term intent test** with an **accounting test** that would have been based on fair value accounting.
 - Under the proposed accounting test, financial instruments that are recorded at fair value on a recurring basis under applicable accounting standards, including a broad range of longer-term positions, would have been captured by the trading account definition.
 - The two other tests in the trading account definition—the market risk capital test (**MRC test**), which applies to certain purchases and sales made by banking entities that calculate risk-based capital ratios under the U.S. market risk capital rule, and the **dealer test**, which applies to certain purchases and sales made by banking entities that are dealers—would largely have been left unchanged by the 2018 Proposal.

Background: The 2018 Proposal

- The 2018 Proposal would have also:
 - Added exclusions from the definition of proprietary trading and revised certain permitted activity exemptions, many of which are implemented in the 2019 Final Amendments and discussed below;
 - Significantly expanded banking entities' **metrics** reporting requirements, including through new qualitative informational requirements; and
 - Categorized banking entities into one of three tiers for **compliance** purposes— Significant, Moderate or Limited—based on the level of trading activity, as measured by reference to a banking entity's trading assets and liabilities (**TAL**).
- Finally, the 2018 Proposal included numerous requests for comment on the covered funds provisions but only a few specific proposals.

The 2019 Final Amendments

- As with the 2018 Proposal, the most significant aspects of the 2019 Final Amendments relate to the proprietary trading provisions of the Volcker Rule, and specifically the definition of trading account. They include:
 - **Dropping the Proposed Accounting Test:** The 2019 Final Amendments do not replace the short-term intent test with the 2018 Proposal’s accounting test under the 2019 Final Amendments; instead, the short-term intent test is preserved with certain modifications.
 - **Modified Short-Term Intent Test:** The 2019 Final Amendments replace the short-term intent test’s rebuttable presumption that financial instruments held for fewer than 60 days are captured by that test with a rebuttable presumption that financial instruments held for 60 days or more are not captured by that test.
 - **MRC Firms:** The 2019 Final Amendments exempt banking entities subject to the MRC test from the modified short-term intent test.
 - **Non-MRC Firms:** The 2019 Final Amendments give banking entities that are not otherwise subject to the MRC test the option to assess their trading account as if they were subject to the MRC test, instead of being subject to the modified short-term intent test.

The 2019 Final Amendments

- **New Exclusions:** The 2019 Final Amendments also expand the exclusion from the definition of proprietary trading for liquidity management and add exclusions for error trades, matched customer-driven derivative transactions for non-dealers, hedges of mortgage servicing rights or assets and non-trading assets or liabilities.
- **Revised Permitted Activity Exemptions:** The 2019 Final Amendments revised the requirements for certain permitted activity exemptions, including by:
 - Introducing a presumption that market making and underwriting trading desks that establish, implement and enforce internal limits that are designed not to exceed the reasonable expected near-term demand (**RENTD**) of customer, clients or counterparties based on specific factors are in compliance with the statutory RENTD requirement.
 - Eliminating certain requirements under the permitted activity exemption for non-U.S. banking entities' trading outside the United States, including the counterparty and financing restrictions.

The 2019 Final Amendments

- Other key aspects of the 2019 Final Amendments include:
 - **Metrics:** The 2019 Final Amendments did not include many of the proposed expansions to the 2013 Rule’s metrics requirements in the 2018 Proposal, and certain metrics included in the 2013 Rule have been eliminated or have been modified to be less burdensome. As a result, the Agencies state that the 2019 Final Amendments will significantly reduce the volume of data to be reported.
 - **Tiered Compliance:** The 2019 Final Amendments retain the three-tiered classification system in the 2018 Proposal based on TAL for tailored compliance requirements, but increase the threshold for banking entities that are subject to the heaviest compliance burdens to \$20 billion of TAL, rather than \$10 billion as proposed.
 - The Significant TAL threshold for a non-U.S. banking entity will be measured based on the TAL of the non-U.S. banking entity’s combined U.S. operations, rather than worldwide TAL as proposed.

The 2019 Final Amendments

- **Covered Funds:** The Agencies adopted as proposed the few specific covered funds changes in the 2018 Proposal, including:
 - **Risk-Mitigating Hedging:** The 2019 Final Amendments permit banking entities to acquire and retain ownership interests in covered funds to hedge certain customer-driven transactions, including for fund-linked products.
 - **Market Making and Underwriting:** The 2019 Final Amendments eliminate the requirement that a banking entity include ownership interests in third-party covered funds or covered funds guaranteed by a banking entity that are acquired or retained under the market making or underwriting permitted activity exemptions towards its per-fund and aggregate covered fund investment limits and for the required Tier 1 capital deduction.
 - **Solely Outside the United States:** The 2019 Final Amendments eliminate the financing restriction in the permitted activity exemption for non-U.S. banking entities' acquisition or retention of ownership interests solely outside the United States.
 - The Agencies will address the bulk of the covered funds provisions in a future notice of proposed rulemaking, presumably with an expanded set of proposed amendments in response to the comments received on the covered funds portion of the 2018 Proposal. The timing of that reproposal is currently uncertain.
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The 2019 Final Amendments

- **Timing:** The effective date of the 2019 Final Amendments is January 1, 2020, with compliance required by January 1, 2021. Banking entities may, however, elect to voluntarily comply, in whole or in part, with the 2019 Final Amendments—once effective—prior to the January 1, 2021 required compliance date.

Updated Proprietary Trading Flowcharts

- Our updated proprietary trading flowcharts are available [here](#).
- As discussed above, the 2019 Final Amendments contain few changes to the covered funds provisions and more amendments to the covered funds provisions are expected to be made through future rulemaking; therefore, our covered funds flowcharts will be updated at a later time.
- A link to Davis Polk's dedicated Volcker Rule page is available [here](#).