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The Volcker Rule: Past, present, and future

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Since April 1, 2014, when the regulations issued by the banking agencies implementing the Volcker Rule became effective, banking entities of various stripes have been busy getting their operations in order to comply with the statute and the regulations. At the same time, banking agencies have been clarifying their expectations on how banking entities should be complying with the law and regulations. Likewise, service professionals, such as law firms and consultancy firms, have been addressing various issues that banking entities should be aware of when complying with the Volcker Rule.

Background

This paper seeks to discuss a number of these issues that have arisen since the April 2014 effective date of the Volcker Rule regulations.

First, it would best to have a quick refresher and ask, "What is the Volcker Rule?" The purpose of the statutory Volcker Rule, found in Section 13 of the Bank Holding Company Act and codified at 12 U.S.C. §1851, is to limit the type and amount of speculative risk that can be undertaken by banking entities that are supported by the public safety net. A final rule, adopted by the Office of the Comptroller of the Currency, Federal Reserve Board, and Federal Deposit Insurance Corporation in December 2013, accomplishes this goal by generally prohibiting banking entities from:

- engaging in short-term proprietary trading of securities, derivatives, commodity futures and options on these instruments for their own account; and
- owning, sponsoring, or having certain relationships with hedge funds or private equity funds, referred to as "covered funds."

Conformance period

In order for the Volcker Rule's restrictions to be effective, banking entities must bring their activities with conformance with the law and regulations within a specified time period. Generally, all banking entities are required to conform their proprietary trading activities by July 21, 2015.

However, given the "unintended consequences" that arose after the banking agencies issued their implementing regulations, it was necessary to reexamine the application of the general Volcker Rule conformance period to a number of activities and investments.

Legacy covered funds. Probably one of the least contentious issues, regarding the conformance period, was the Federal Reserve Board's extension of the conformance period for certain legacy covered funds. The Fed took this action in December 2014.

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With the extension, banking entities have until July 21, 2017, to conform their covered funds that were in place before December 31, 2013. Specifically, the Fed's action extended the conformance period until July 21, 2016, with the option to add one year, effectively extending the conformance period until July 21, 2017.

The Fed took this action based on calls from banking entities, private equity funds, trade associations, and members of Congress that the conformance period should be extended for a number of reasons.

Orderly sales and restructuring. The commenters maintained that, because banking entities were "permitted to make and did make significant investments in many thousands of covered funds" prior to the adoption of the banking agencies' Volcker Rule regulations, additional time was necessary to determine whether these legacy funds investments can be conformed to the statute or must be divested. They further asserted that extra time was needed to allow for the orderly sale of covered fund interests that must be divested, including divestitures that must, by statute, be made by employees, officers, and directors of banking entities. Another justification for the extension was the need to consult with investors in and managers of covered funds regarding the statutory requirements to change the names of covered funds.

Private funds that are sponsored by non-banking entities also called for the extension because they needed additional time to restructure, conform, redeem, or sell investments in connection with a number of investors in their funds that included foreign banks subject to the Volcker Rule and its implementing regulations.

A final argument for an extension of the conformance period was based on the fact that certain foreign funds have some activities in the United States and that these funds' managers and investors needed to determine whether they must take steps to modify their sales practices, governance, or ownership structure to ensure compliance with various provisions of the Volcker Rule.

Reducing disruptive effects. In granting the conformance period extension until July 17, 2017, the Fed noted that its decision was consistent with protecting the safety and soundness of these banking entities. The agency added that the extension "would also reduce the potential disruptive effects that significant divestitures of covered funds could have on markets and on the investments of others not subject to [the Volcker Rule], as well as allow banking entities additional time to work with other investors and investment managers to take steps to conform covered funds to the requirements of the statute and the final rule (such as by issuing disclosures, changing fund names, and conforming employee investments)."

Good faith efforts. Although banking entities have until July 21, 2017, to conform their legacy covered funds, each entity is "expected to engage in good-faith efforts to conform of all its activities and investments to the requirements of [the Volcker Rule]." A bank entity engages in good-faith efforts by: (1) evaluating the extent to which its activities are covered by the Volcker Rule and the banking agencies' implementing regulations; and (2) developing and implementing a conformance plan that is appropriately specific about how the banking entity will fully conform all of its covered activities and investments by the end of the applicable conformance period.

Super 23A impact. In a Banking and Financial Services Update, the law firm Sidley Austin LLP noted that the Fed's extension "did not provide significant guidance regarding either the meaning of 'relationships' or the related activities after the December 2013 cutoff date that will be covered by the Extension Order." The law firm observed that "in the context of discussing relationships generally, the Extension Order cited [in footnotes 6 and 7 of the Order] not only the prohibition on banking entities' sharing their names with sponsored covered funds but also the Volcker Rule's so-called Super 23A prohibitions. This suggests that the requisite relationship exists where Super 23A prohibitions would be triggered." The firm concluded that because the "Extension Order focuses on the existence of relationships at year end, and not the completion of particular related transactions, the Extension Order suggests that 'covered transactions' subject to Super 23A that are executed post-2013 will benefit from the Extension Order's relief if they arise out of a qualifying pre-existing relationship."

Needed breathing room. In a Financial Services LawFlash, Charles M. Horn and Melissa R. H. Hall of Morgan, Lewis & Bockius LLP said the conformance period "only postpones the inevitable" but conceded that "additional time will give the banking and investment communities some much-needed breathing room to reconfigure and adjust their covered fund activities and investments."

Legacy CLOs. Unlike the Fed's extension of the conformance period for legacy covered funds, how much time banking entities have to bring their activities and investments in a debt security of collateralized loan obligation (CLO) into compliance with the Volcker Rule seems to be a more contentious issue.

Although the Fed extended the conformance period to July 21, 2015, and signaled that it intended to "grant

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banking entities two additional one-year extensions, which together would extend until July 21, 2017, to conform their ownership interests in and sponsorship of CLOs to the statute," the Fed's April 2014 action is still subject to possible congressional action.

The CLO issue arose shortly after the banking agencies adopted their regulations implementing the Volcker Rule. At that time, there was a concern related to a totally different financial instrument—collateralized debt obligations backed by trust-preferred securities, which are commonly called "TruPS-backed CDOs" and were a means by community banks raised capital.

Tru Ps fix. The American Bankers Association, along with a number of banking organization filed a lawsuit seeking a halt of the application of the Volcker Rule regulations to TruPS-backed CDOs. The lawsuit was eventually dropped once the banking agencies issued an interim final rule permitting banking entities to retain some investments made before December 10, 2013. Specifically, the interim final permitted banking entities to retain an interest in, or to sponsor, entities that issued affected CDOs, provided that: (1) the issuer was established before May 19, 2010; (2) the bank entity reasonably believes that the proceeds of the offering were invested primarily in qualifying collateral; and (3) the bank entity's investment in the issuer was made before December 10, 2013, or was acquired by a merger or acquisition.

Address unintended consequences. Following the January 2014 interim rule, the banking industry advocates pressed Congress to take further action to address the CLO issue. For instance, the U.S. Chamber of Commerce's Center for Capital Markets Competitiveness (CCMC) asked the banking agencies, as well as the Securities and Exchange Commission and Commodity Futures Trading Commission, to address the "unintended consequences" that application of the Volcker Rule regulations was having CLOs. In its letter, the CCMC noted that banks owned about $70 billion worth of CLO debt and that efforts to restructure this amount of debt would be "overwhelming" and "remove a major source of liquidity from the CLO market, and make it harder for businesses that need the CLO market for loans to find the financing that they need to operate grow and create jobs."

Congressional action on the CLO issue first appeared in H.R. 4167, a bill introduced in March 2014 by Rep. Andy Barr (R-Ky). The legislation, the "Restoring Proven Financing for American Employers Act," would have would have extended the conformance period until July 21, 2017, which would have been the same conformance period that the Fed signaled that it would have adopted in its April 2014 action.

The bill also would have clarified that a bank will not be considered to have an ownership interest in a CLO for purposes of enforcement of the Volcker Rule if a debt security has no indicia of ownership other than the right to participate in removal for cause or in the selection of a replacement investment manager or investment adviser of the CLO.

Current underwriting processes could be "Volckerized" to meet RENTD compliance

Regulatory overreach. During the floor debate on H.R. 4167, Rep. Scott Garrett (R-NJ), the current Chairman of the House Subcommittee on Capital Markets and Government Sponsored Enterprises, called the Volcker Rule treatment of CLOs as "an egregious example of regulatory overreach." The bill's sponsor, Rep. Barr quoted the Kentucky Bankers Association assessment of CLO as "a 'conservative addition to an existing and balanced investment approach' and a 'thoughtful solution to the equity problem' that banks face." He added that, without the legislation, there would be "a fire sale in the market that will cause significant losses to banks currently holding what are known as legacy CLOs."

What's being solved? On the other hand, Rep. Michael Capuano (D-Mass) countered that over 70 percent of the CLOs were held by "only three of the largest banks in the world" and that almost all of those CLOs would be permitted to those three large banks. He queried, "So what are we solving here? We are pretending to save some great investment tool." Capuano added, "So let's be clear: CLOs are not being killed. They are being limited in a very small way only to target the most risky CLOs. Banks and others have already adjusted to those limitations by reinvigorating the CLO market in a way that has been and would be allowed under the existing rule. But yet we have a problem."

Following the debate, H.R. 4167 was approved by a voice vote on April 29, 2014, sent to the Senate, and died when the 113th Congress adjourned.

Rise of phoenix. Despite the death of H.R. 4167, it arose like a phoenix at the start of the 114th Congress

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and became part of H.R. 37, the "Promoting Job Creation and Reducing Small Business Burdens Act," which is a package of 11 bills that contains, among other things, changes to provisions relating to regulation of derivatives under the Dodd-Frank Act. Under Section 801 of H.R. 37, banking entities and nonbank financial companies would have until July 19, 2019, to bring their activities and investments in a debt security of collateralized loan obligation into compliance with the Volcker Rule. The conformance-period extension would only apply to CLOs issued before July 31, 2014. The ownership provisions found in the original version of H.R. 4167 were stripped out of H.R. 37. The House approved H.R. 37 by a vote of 271 to 154 on January 14, 2015; an earlier attempt at House passage failed to garner a required 2/3 majority on January 7, 2015.

Battle of the numbers. In between the House votes on H.R. 37, advocates for and against the bill came out firing.

The consulting firm Hamilton Place Strategies released an analytical piece dispelling some of the myths surrounding the extended conformance period. The firm noted that H.R. 37 "designed to avoid fire sales caused via phased-in compliance for legacy CLOs has been supported by Members of both parties, the broader business community, and banks of all sizes." The analysis also noted that smaller bank holding companies are disproportionately affected relative to their CLO investments and overall capital base, and CLOs have a cumulative 20-year default rate of 0.41 percent. In addition, the analysis stated that the OCC "estimated that losses from forced divestitures could lead to $3.6 billion in losses." Finally, Hamilton Place Strategies stressed that the CLO fix in H.R. 37 cannot be described as a rollback of Dodd-Frank or the Volcker Rule. Proprietary trading is still banned. Taking an ownership stake in hedge funds is still banned. Divesting non-compliant CLOs is still required. The only change is that banks will have two additional years to divest themselves of legacy CLOs.

The Financial Services Roundtable (FSR) came out in support of H.R. 37 by sending a letter of support to House leaders. The letter stated that FSR believes H.R. 37's technical changes to the Volcker Rule will improve the underlying statute while keeping the Volcker Rule fully in place. "This bill's changes would allow financial institutions more time to conform their holdings of collateralized loan obligations under new regulations adopted under the Volcker Rule. This time extension will help ensure that an important market for corporate financing is not disrupted. This is a minor, but important change in timing that will be beneficial to the economy," FSR's Vice President of Government Affairs Francis Creighton said.

Brazen attempt. On the other hand, the nonprofit, nonpartisan organization, Better Markets issued a "Fact Sheet" calling the extension of the conformance period "nothing more than a brazen attempt by [the biggest Wall Street] banks to continue speculating in risky products with taxpayer funds" and "allows more time for this backdoor proprietary trading to continue." The fact sheet noted that 69 percent of U.S. bank-held CLOs are owned by just four banks. It added that "the Volcker Rule already provides both ample time to divest these sought-after instruments, and a variety of ways to bring existing CLOs into compliance with the rule." In addition, the fact sheet stated, "CLOs backed entirely by loans are excluded from the Volcker Rule and many CLO holdings are not considered 'ownership interest' under the Volcker Rule."

Also, Alexis Goldstein, Communications Director at the non-profit organization The Other 98%, set about to debunk the analytical piece by Hamilton Place Strategies. In her piece, "Debunking the Chatter: The Truth about Wall Street's Volcker Rule Assault," Goldstein noted, that "[t]he Hamilton materials say a lot of things that aren't accurate." Alluding to the $3.6 billion in losses due to forced divestitures of the CLOs, Goldstein noted that "[a]fter poking around a bit to find the potential source of the number, it seems like the figure comes from the OCC's economic analysis of the 'costs' of the Volcker Rule. And upon a cursory examination, the $3.6 billion figure in the bank talking points bears no connection to any observable reality."

Significant concern. Even the White House weighed in on H.R. 37. In a Statement of Administrative Policy, the Obama Administration stated it had "significant concerns" over delaying the conformance period for CLOs until 2019.

Finally, it should be noted that Rep. Barr quietly introduced his latest version of the "Restoring Proven Financing for American Employers Act" as H.R. 1841. The bill is actually identical to Section 801 of H.R. 37.

Agencies' expectations

The first glimpse of what the OCC, Fed, and FDIC expect of banking entities in complying with the Volcker occurred in June 2014 when the OCC released a set of interim examination procedures. The *interim procedures* were to be used by examiners to assess banks' progress in developing a framework to

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comply with Volcker Rule and the banking agencies' implementing regulations.

Roadmap to compliance. Although the OCC noted that the procedures will apply to examinations of national banks, federal savings associations, and federal branches and agencies of foreign banks, banking entities supervised by the Fed and FDIC could use the procedures as a roadmap for their own compliance obligations.

The examination procedures focus on three areas: general procedures, proprietary trading, and covered funds.

Bank progress. In the "general procedures" portion of an examination, an examiner will assess a bank's progress toward identifying activities subject to the regulations and establishing a compliance program. The examiner will also assess a bank's plan for avoiding material conflicts of interest and material exposures to high-risk assets and high-risk trading strategies.

Proprietary trading. The "proprietary trading" portion of the examination procedures require an examiner to assess a bank's progress toward:

- reporting metrics as and when required;
- using the metrics to monitor for impermissible proprietary trading;
- identifying its market-making-related activities, market-maker inventory, and reasonably expected near-term demand;
- establishing a compliance program for permitted market-making-related activities;
- establishing a compliance program for its underwriting activity; and
- establishing a compliance program for its risk-mitigating hedging activity and satisfying the regulations' documentation requirements.

Covered funds. Finally, the examination procedures involving covered funds are intended to assess a bank's plan to:

- conform asset management and sponsorship activities;
- conform securitization activities involving a securitization vehicle that is a covered fund;
- conform underwriting and market-making activities in covered funds;
- ensure compliance with the de minimis ownership limits on investments in covered funds relevant to the permitted asset management, securitization, underwriting, and market-making activities;
- conform hedging activities using covered funds; and
- divest nonconforming investments in covered funds.

Clarifying agencies' expectations

To clarify the agencies' expectations on how banking entities are to comply with the provisions of the Volcker Rule, the staffs of the three banking agencies, along with the Securities and Exchange Commission and Commodity Futures Trading Commission, have periodically released a series of Frequently Asked Questions.

Anti-evasion is a critical issue to watch in 2015

FAQs. The first set of FAQs was released in June 2014 and elaborated on applicable definitions and exemptions and was designed to assist banking entities in maintaining compliance with recordkeeping and reporting obligations. They also covered: the breadth of the term "trading desk" and related reporting obligations; how to comply with the conformance period requirements; application of the "covered fund" exclusions for loan securitizations and foreign public funds; and the naming of covered funds and banking entities.

CEO attestation. In a September 2014 update, the agencies' staff discussed when a banking entity, which is subject to the enhanced minimum standards for compliance program requirements under the agencies' regulations, must file its annual first annual CEO attestation to the relevant agency.

Metric reporting. A third update was released in November 2014 and discussed metrics reporting during the conformance period and treatment of mortgage-backed securities issuers sponsored by government-sponsored enterprises under the final rule's covered funds provisions.

An update, issued in late December 2014, examined whether the metrics data that a banking entity must report under Appendix A of the final rule is protected by the Freedom of Information Act.

The first update of 2015 clarified the metrics reporting deadlines during the conformance period for proprietary trading activities and discussed the applicability of the proprietary trading exceptions found in the agencies' regulations to the principal and interest components of the Treasury Department's Separate Trading of Registered Interest and Principal of Securities (STRIPS) program.

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SOTUS exemption. The most recent FAQ discussed the scope of the "marketing restriction" found in the "SOTUS covered fund exemption," which is codified at 12 C.F.R. §248.13(b) of the Fed's final rule. That exemption applies to certain covered fund activities conducted by foreign banking entities, provided that, among other conditions, "no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the United States"—the marketing restriction. In their analysis, the agencies' staff stated that the marketing restriction serves to limit the SOTUS covered fund exemption so that it "does not advantage foreign banking entities relative to U.S. banking entities with respect to providing *their* covered fund services in the United States by prohibiting the offer or sale of ownership interests in *related* covered funds to residents of the United States."

Working with RENTD

As the July 21, 2015, deadline for banking entities to conform their proprietary trading activities to the Volcker Rule requirements draws near, the application of the "reasonably expected near term demand" (RENTD) provisions of the Volcker Rule and the banking agencies' implementing regulations play a much greater role.

The RENTD provisions allow a banking entity to avail itself to the Volcker Rule's proprietary trading exemptions.

A banking entity can use the underwriting exemption to act as an underwriter for a distribution of securities, for both public and private offerings. This exemption is available only if the trading desk's underwriting position is related to that distribution and if the underwriting position does not exceed the reasonably expected near-term demands of customers.

The market-making exemption is available to a banking entity's trading desk as long as the trading desk is routinely standing ready to purchase and sell one or more types of financial instruments. The trading desk's inventory in these types of financial instruments would have to be designed not to exceed, on an ongoing basis, the reasonably expected near-term demands of customers based on such things as historical demand and consideration of market factors. A market-making desk may hedge the risks of its market-making activity under this exemption, provided it is acting in accordance with certain risk-management procedures required under the banking agencies' final rule.

In the first quarter of 2015, PwC's Financial Services Regulatory Practice released two Regulatory briefs discussing various issues surrounding the RENTD provisions of the Volcker Rule and the banking agencies' implementing regulations.

Market making RENTD. In the first Regulatory brief, *Volcker Rule: Are you really market making?*, PwC noted that "RENTD is fundamental to the Volcker Rule, as it is the essential evidence needed to show that the positions of a desk taking the market making exemption are tied to customer activity." The firm added that determining RENTD "has caused banks much confusion around whether RENTD itself is a limit (which it is not) and frustration due to data challenges" and "[c]apturing and analyzing the data required to calculate RENTD has become an enterprise-wide conundrum."

Tactical and strategic solutions. The takeaway from this brief is that banking entities should be on their way "implementing tactical and strategic solutions while increasing enterprise-wide awareness and education of RENTD requirements." PwC concluded that "RENTD is likely here to stay and the sooner firms embrace it, the sooner it will become an effective risk management tool that will demonstrate a bank's commitment toward restricting proprietary trading."

Underwriting RENTD. PwC's second Regulatory brief, *Volcker underwriting: It's simple ... no need to overanalyze*, examines the RENTD requirements as they apply to the underwriting exemption.

The brief explained that the underwriting RENTD is the anticipated market demand for an underwritten deal's securities estimated as a monetary range. To comply with the Volcker Rule requirements, a banking entity's underwriting desks need to take RENTD into account when setting three limits intended to prevent proprietary trading: the size of a desk's underwriting positions, the length of time residual positions can be held, and the risks arising from certain underwriting support activities.

Volckerize processes. PwC suggests that banks "should be able to leverage existing processes for setting and monitoring a trading desk's underwriting limits," thereby complying with the Volcker Rule's underwriting exemption requirements. PwC stressed that the "key is to highlight existing underwriting processes and 'Volckerize' them to make them part of the compliance program.

Looking over the horizon

In an early 2015 *Client Alert* by Frank A. Mayer III, Timothy R. McTaggart, and Andrew J. Victor of the law firm Pepper Hamilton LLP, the anti-evasion provision of the Volcker Rule was called a "critical regulatory issue to watch in 2015."

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Significant challenges. The authors noted that the agencies' implementing regulations did not "further describe or provide guidance regarding the enforcement power under the anti-evasion regulatory provision and, instead, hewed closely to the statutory language." As a result, they stated, "the anti-evasion provision raises significant interpretative challenges for industry participants and practitioners."

Although there is little regulatory guidance on how the anti-evasion provisions would be applied by the agencies, the authors "walked through" a possible scenario on how the agencies would apply the anti-evasion provisions by using the statutory language.

Expansive tools. They noted, "Looking to the statute's plain language, the anti-evasion provision is an expansive tool." For example, an agency has a low threshold, a "reasonable belief" to bring a regulatory enforcement response, "which can provide for a wide spectrum of interpretation when [an agency] is scrutinizing an investment or activity." The authors added that a banking entity's intent to evade the Volcker Rule is not a factor because "the offending investment or activity only needs to function like an evasion, or otherwise violate the Volcker Rule."

Cautionary tale. Finally, the authors cautioned banking entities that qualify as foreign banking organizations under the Volcker Rule that they "could be exposed to regulatory risk from the anti-evasion provision in moving, from the United States to an offshore location, covered activity, such as proprietary trading." They suggest that if "a foreign banking organization decides to restructure its operations in this manner, it will need to develop a comprehensive approach and document a clear business purpose for moving its operations offshore, lest such a change be deemed an evasion of the Volcker Rule."

About the Author

John M. Pachkowski is an attorney and senior banking analyst at Wolters Kluwer Law & Business who has over 25 years of experience tracking and explaining banking developments for *Federal Banking Law Reports* and the *Banking and Finance Law Daily*. John is co-author of the *Dodd-Frank Wall Street Reform and Consumer Protection Act — Law, Explanation and Analysis*, as well as *Financial Services Modernization – Gramm-Leach-Bliley Act of 1999 – Law and Explanation, Federal Privacy Rules for Financial Institutions, Guide to Anti-Money Laundering,* and *Bank Secrecy: Compliance and USA PATRIOT Act*. He also developed the *Federal Banking and Securities QuickCharts—Volcker Rule* that provides information about the ability of banking entities to engage in proprietary trading activities or have relationships with hedge funds and private equity funds requirement under the Volcker Rule regulations. The chart is organized by topic including treatment of proprietary trading; covered fund activities and investments; and compliance programs. John offers insight on a wide range of issues affecting the changing financial services industry.

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