Agencies Release Volcker Rule FAQs on Treatment of Residual Market-Making Positions and Certain Timing Issues Related to the "Super 23A" Prohibition

Last Friday, the agencies responsible for implementing the Volcker Rule (the "Agencies") released two new frequently asked questions ("FAQs"). FAQ 19 relates to the treatment of certain residual market-making positions under the Volcker Rule's proprietary trading prohibition. FAQ 20 addresses certain questions related to the timing of the application of the "Super 23A" prohibition on entering into covered transactions with related covered funds.

FAQ 19: Treatment of Residual Market-Making Positions

FAQ 19 provides helpful clarification of a discrete issue that arose in connection with legacy, or residual, market-making positions, many of which were acquired before the financial crisis. The FAQ provides flexibility to banking entities to manage the dispositions of (or exits from) legacy positions in a commercially reasonable timeframe without contravening the Volcker Rule's prohibition on proprietary trading. When the FAQ is understood against the backdrop of the various discussions that led up to its publication, it appears that the Agencies were not intending to limit other means of complying with the Volcker Rule with respect to legacy positions, some of which should remain available as alternatives to the path established by the FAQ.

In the normal course, banking entities are expected to make strategic decisions about the relative value of continuing various lines of business. In the context of the Volcker Rule, exiting a market-making business line may mean that a banking entity no longer acts in response to customer demand, or may no longer be standing ready to purchase and sell positions related to the desk's mandate.

FAQ 19 helpfully addresses this situation, by providing relief to a market-making business unit after the end of its life cycle from the requirements of the market-making exemption in Section __.4(b) of the Volcker Rule implementing regulations (the "Final Rule"), provided that the business unit exits the "residual" positions as soon as commercially practicable and the business unit hedges the risks of any such residual positions under the risk-mitigating hedging exemption of Section __.5 of the Final Rule.

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We do not believe the references in the FAQ to needing to hedge the residual positions should be understood to create a more stringent standard of hedging in the context of residual market-making positions, different from other situations in which a banking entity may be relying on the hedging exemption. The preamble to the Final Rule details the flexibility and discretion provided to a banking entity under the rule. It explains that the risk-mitigating hedging exemption is intended to provide "flexibility to recognize differences in hedging activity across markets and asset classes"[1] and the Agencies acknowledged that "the complexity of positions, market conditions at the time of the transaction, availability of hedging transactions, costs of hedging and other circumstances at the time of the transaction"[2] are permitted to be taken into account.

FAQ 19 also charts a more viable course than what, based on some informal feedback from the Agencies, appears to have been under consideration at an earlier stage. Not only are residual positions not deemed proprietary trading if they are treated in accordance with FAQ 19, but (1) the FAQ explicitly rejects any need to engage in a "fire sale" of positions merely because the managed exit of the positions is no longer being conducted in accordance with the market-making exemption, and (2) there also should be no need to "freeze" positions (i.e., to stop any semblance of "trading"), as the FAQ permits both dynamic management of the exit of the positions and dynamic hedging of the positions pursuant to the risk-mitigating hedging exemption.[3]

Adherence to FAQ 19's standards, however, may not be without cost. Given the previous lack of guidance on how to address these strategic exit decisions, the industry has taken diverse approaches to the issue. Those banking entities that may have, in good faith, continued with a market-making approach for exiting residual positions, should consider whether the business unit in question is still conducting business in accordance with the requirements of the market-making exemption, or should consider adopting a different approach involving risk-mitigating hedging and its attendant correlation analysis requirement. Banking entities should also explore the effect, if any, of FAQ 19 on other interpretive positions that may have been taken, such as "outside the trading account" determinations for positions to be exited, or "freezing" of activity in certain business units. While it may be that the concept of such approaches remains independently viable, the practicality, scope and appropriateness of such concepts should be revisited in light of the statements in FAQ 19. Furthermore, based on the background discussions that led to FAQ 19, the applicability of the FAQ beyond its literal language to other "legacy", "wind-down" or "bad bank" positions that existed prior

[1] 79 Fed. Reg. 5536, 5629.

[2] 79 Fed. Reg. at 5632.

[3] 79 Fed. Reg. at 5636 ("The Agencies recognize that markets and risks are dynamic and that the risks from a permissible position or aggregated positions may change over time, new risks may emerge in the positions underlying the hedge and in the hedging position, new risks may emerge from the hedging strategy over time, and hedges may become less effective over time in addressing the related risk. The final rule, like the proposal, continues to allow dynamic hedging.")

to the Volcker Rule conformance date (and that may pre-date the financial crisis) should also be considered.

As this FAQ has been released after the Volcker Rule conformance period for trading businesses, and well after banking entities had made good faith decisions about the proper approach to legacy or residual positions, we believe the Agencies are likely to provide a reasonable period of time to conform, if necessary, to the requirements of FAQ 19. What period may be appropriate is likely to depend upon individual facts and circumstances, and banking entities should discuss any relevant policy, procedure or interpretive changes with their examiners.

FAQ 20: Applicability of "Super 23A" to Existing and Other Covered Transactions with Related Covered Funds

FAQ 20 addresses questions related to the timing of the Super 23A prohibition in a manner that is consistent with our understanding of the current market view of how the prohibition applies.

The FAQ confirms that covered transactions entered into with related covered funds before July 21, 2015 ("existing covered transactions") generally may wind up according to their terms and do not need to be terminated or otherwise conformed. This is consistent with the prospective nature of the statutory and Final Rule language, as the "Super 23A" prohibition provides that a banking entity may not "enter into" covered transactions with related covered funds.[4] Neither the statutory language nor the Final Rule require termination of existing covered transactions. Prior to issuance of FAQ 20, there was some uncertainty about the effective date of the prohibition, and therefore the final date when a banking entity could have entered into a covered transaction that would not have to be terminated.

FAQ 20 also points out that material amendments to an existing covered transaction — such as an increase in the committed amount, extension of the maturity, or adjustment to the interest rate — would generally result in a new covered transaction. This principle is consistent with Federal Reserve Board regulations and guidance interpreting Section 23A of the Federal Reserve Act.[5]

The Agencies also caution that for a covered transaction with a related covered fund relying on the asset management exemption in Section __.11 of the Final Rule, the banking entity must also evaluate whether the covered transaction complies with that exemption's prohibition against the banking entity guaranteeing, assuming or otherwise

[4] See 12 U.S.C. § 1851(f)(1). See also Final Rule, Section __.14(a).

[5] See, e.g., 12 C.F.R. § 223.3(o)(5).

insuring obligations of the fund.[6] In other words, an existing covered transaction that would be permissible under Super 23A because it was not "entered into" after July 20, 2015 might in some cases nevertheless prevent the banking entity from relying on the asset management exemption in relation to a fund due to the separate prohibition against guaranteeing or assuming obligations of the fund.

Finally, FAQ 20 addresses the application of the Federal Reserve Board's order extending the conformance period for certain investments in and relationships with covered funds that were in place prior to December 31, 2013 ("legacy covered funds").[7] We read the FAQ to affirm the view that under the legacy funds extension order, banking entities may continue to enter into new covered transactions with legacy covered funds during the extended conformance period (i.e., between July 2015 and July 2017), if such new transactions are tied to a legacy (i.e. pre-2014) relationship with a legacy covered fund and are consistent with good-faith conformance efforts. However, in our view, the Agencies will likely expect that generally such new covered transactions will be terminated by the end of the extended conformance period.

The text of the new Volcker Rule FAQs is below.

Termination of Market-Making Activity: Treatment of Residual Positions

19. If a banking entity exits a market-making business permitted under the final rule, how may the banking entity sell or unwind its residual market-making positions? How may the banking entity hedge its residual market-making positions under the final rule?

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For business reasons or otherwise, a banking entity may determine to exit a particular line of business or trading activity that is permissible under the final rule. In the event that a banking entity terminates a market-making business that it conducted as a Volcker Rule permitted activity,[52] a situation could occur where the banking entity holds residual positions from its prior market-making activity.

In the view of the Agencies' staffs, the banking entity may hold and dispose of these residual market-making positions, provided (i) the banking entity hedges the risks of any such positions in accordance with the risk-mitigating hedging exemption[53] and (ii) the banking entity sells or unwinds the residual market-making positions as soon as

[6] See Final Rule, Section __.11(a)(5).

[7] See Order Approving Extension of Conformance Period under Section 13 of the Bank Holding Company Act (December 18, 2014) available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20141218a1.pdf.

commercially practicable. If a banking entity holds residual market-making positions and does not hedge the risks of such positions, then the subsequent sales of those residual positions would generally be considered proprietary trading under the final rule implementing section 13 of the BHC Act.[54]

When hedging the risks of the residual market-making positions, the banking entity must comply with the requirements of the risk-mitigating hedging exemption.[55] A banking entity cannot rely on the market-making exemption to manage the risks of its residual market-making positions. The market-making exemption only permits risk management activity conducted or directed by a trading desk in connection with the desk's permitted market making-related activities conducted in conformance with all of the requirements of the market-making exemption set forth in the final rule.[56]

52. *See* § 248.4(b).

53. *See* § 248.5.

54. *See* § 248.3(b)(1).

55. *See* § 248.5.

56. *See* § 248.4(b)(2), 79 FR at 5576-5627.

Applicability of the Restrictions in Section 13(f) of the BHC Act

20. When does a banking entity become subject to the restrictions of section 13(f) and section 248.14 of the final rule with respect to a covered transaction with a covered fund? What about existing covered transactions?

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Section 13(f) of the BHC Act provides that no banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund ("covered fund"), or that organizes and offers a covered fund pursuant to section 13(d)(1)(G), and no affiliate of such entity, may enter into a transaction with the fund, or with any other covered fund that is controlled by such fund, that would be a covered transaction as defined in section 23A of the Federal Reserve Act (12 U.S.C. 371c) ("covered transaction"), as if such banking entity and the affiliate thereof were a member bank and the covered fund were an affiliate thereof.[57] Section 248.14 of the final rule implements this statutory restriction.[58]

The statute gave banking entities a conformance period until July 21, 2014 to comply with the requirements of the Volcker Rule, and the Board extended this period by one year at the time of issuance of the final rule until July 21, 2015.[59] As a general matter, on or after July 21, 2015, a banking entity may not enter into a covered transaction with

a covered fund where the banking entity serves as investment manager, investment adviser, or sponsor to the covered fund or relies on the exemption in section 13(d)(1)(G). Staffs of the agencies believe that this restriction would apply to any increase in the amount of, extension of the maturity of, or adjustment to the interest-rate[60] or other material term of, an existing extension of credit.[61] In addition, with respect to any existing covered transaction, a banking entity should evaluate whether the transaction guarantees, assumes or otherwise insures the obligations or performance of the covered fund (or of any covered fund in which such covered fund invests) as prohibited by section 248.11(a)(5) of the final rule.[62]

The conformance period for legacy investments in and relationships with a covered fund (i.e., investments made and relationships entered into by a banking entity prior to December 31, 2013) currently ends on July 21, 2016.[63] Staffs of the Agencies would expect a banking entity to engage in good-faith efforts during the conformance period to ensure that its investments in and relationships with legacy covered funds conform to section 248.14 of the final rule by the end of the applicable conformance period.[64]

57. *See* 12 U.S.C. 1851(f).

58. *See* 12 CFR 248.14(a).

59. *See* 12 U.S.C. 1851(c)(2); *see also* Board Order Approving Extension of Conformance Period (Dec. 10. 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.

60. A floating-rate loan does not become a new covered transaction whenever the interest rate changes as a result of an increase or decrease in the index rate. If the banking entity and the borrower, however, amend the loan agreement to change the interest rate term, for example, from "LIBOR plus 100 basis points" to "LIBOR plus 150 basis points," or from reference to the LIBOR index to the banking entity's prime rate, the parties have engaged in a new covered transaction. *See*, *e.g.*, Transactions Between Member Banks and Their Affiliates, 67 FR 76,560, 76,570 n.67.

61. This is based on the definition of "extension of credit" under the Board's Regulation W promulgated under the Federal Reserve Act. *See*, *e.g.*, 12 CFR 223.3(o)(5).
62. A banking entity must be in conformance with the requirements of the final rule, including as applicable the requirements of section 13(d)(1)(G), with respect to non-legacy covered funds (i.e., a covered fund which a banking entity sponsored or invested in after December 31, 2013) following July 21, 2015.

63. The Board granted banking entities until July 21, 2016, to conform investments in and relationships with covered funds that were in place prior to December 31, 2013, and announced its intention to act next year to grant banking entities until July 21, 2017, to conform investments in and relationships with legacy covered funds. *See* Board Order Approving Extension of Conformance Period under Section 13 of the Bank Holding Company Act (December 18, 2014) (hereinafter "Board's

Conformance Period Order"), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20141218a.htm.

64. *See* Board's Conformance Period Order.

Volcker Rule Frequently Asked Questions

http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm

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