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Financial Institutions Regulation Group Client Alert: Do Some Derivatives Qualify under the Volcker Rule for the Liquidity Management Exclusion from the Proprietary Trading Prohibition?

This is a piece in our continuing series exploring the effects of the Volcker Rule;[1] for previous alerts please click here.

BRIEF BACKGROUND

Chapter 13 of the Bank Holding Company Act, as amended, (the "Volcker Rule") and the final rules issued thereunder[2] prohibit covered banking entities[3] from engaging in proprietary trading of financial instruments. "Proprietary trading" is defined as effecting any purchase or sale of a "financial instrument" as principal for the trading account of a banking entity. Further, a "financial instrument" includes almost all derivative instruments. Therefore, once the Volcker Rule's proprietary trading ban goes into effect on July 21, 2015, covered banking entities will not be permitted to trade derivatives as principal.

However, the agencies that promulgated the final Volcker Rule (the "Agencies") provided certain exclusions and exemptions from the general ban for certain types of trading. These permissible trading activities were considered appropriate to achieve valued results, and their public benefit was deemed to outweigh the possibility of their being covertly used to engage in proprietary trading.

[1] 12 U.S.C. § 1851.
[2] *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 79 Fed. Reg. 5536 (Jan. 31, 2014).
[3] The final rule defines covered "banking entities" to include any of the following, unless otherwise exempted:

(i) Any insured depository institution;
(ii) Any company that controls an insured depository institution;
(iii) Any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978; and
(iv) Any affiliate or subsidiary of an entity described above.

12 C.F.R. § 248.2(c).

WHAT IS THE SPECIFIC ISSUE UNDER THE VOLCKER RULE BEING DISCUSSED?

In the adoption of final rules implementing the Volcker Rule, the Agencies determined that certain types of trading would not be considered proprietary trading. As one example, the Agencies found that "[a]ny purchase or sale of a security by a banking entity for the purpose of liquidity management in accordance with a documented liquidity management plan" would not be proprietary trading, and would therefore be permitted.[4] The Agencies recognized that "liquidity management activity serves the important prudential purpose, recognized in other provisions of the Dodd-Frank Act ..., of ensuring banking entities have sufficient liquidity to manage their short-term liquidity needs."[5]

In order to take advantage of the liquidity management exclusion, the banking entity must have a liquidity management plan that meets six enumerated criteria (discussed below) that are designed to ensure that the banking entity manages its liquidity in a prudent manner and does not abuse the availability of the exclusion to engage in proprietary trading.

WHY IS THE LIQUIDITY MANAGEMENT EXCLUSION LIMITED TO THE PURCHASE OR SALE OF SECURITIES?

As noted above, the liquidity management exclusion applies solely to the "purchase and sale of securities." This formulation indicates that transactions in financial instruments that do not meet the definition of "securities" are excluded. Indeed, the word "security" (or "securities") is used eight times in the short description of the exclusion.[6] In contrast, the proposed Volcker Rule did not contain such a limitation, instead referring to "instrument," "transaction," "position" or "financial instrument" when discussing what product would qualify for the exclusion.[7] Presumably, any form of financial instrument, including those that do not qualify as "securities," would have satisfied the proposed rule, so long as the transaction met the listed eligibility criteria.

The change from a broader set of eligible financial instruments in the proposed rule to the limitation in the Volcker Rule to securities is not discussed in the preamble to the Volcker Rule, which states only that the limitation is consistent "with the liquidity management requirements proposed by the Federal banking agencies".[8] The Agencies leave unexplained why *bona fide* liquidity management actions in financial instruments other than securities should not fall within the exclusion, noting only that such transactions might separately meet the standards for the

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[4] 12 C.F.R. § 248.3(d)(3).
[5] 79 Fed. Reg. 5555, at footnote 239.
[6] 12 C.F.R. § 248.3(d)(3). However, we note the use of the term "other instruments" in prong 4. We assume that this phrase refers to non-financial instruments used for liquidity management purposes, such as certificates of deposit or other cash-like instruments. While banking entities are free to trade in non-financial instruments without reference to any Volcker Rule restrictions, the Agencies appear to state that they will consider the appropriate aggregate limit of a banking entity's liquidity management needs when looking to determine whether the amount of trading under the liquidity management exclusion is appropriate.
[7] 76 Fed. Reg. 66846, 68862, at 113 and accompanying discussion (Nov. 7, 2011).
[8] 79 Fed. Reg. 5555, at footnote 240 and accompanying discussion.

risk-mitigating hedging exemption.[9] While commentators have speculated on the effect of the "London Whale" loss on the views of the Agencies relating to the appropriate exclusion for liquidity management and the appropriate exemption for risk-mitigating hedging, this clearly significant event goes unmentioned except as a possible allusion in an explanation that the liquidity management exclusion is unavailable for any activity that exposes a covered banking entity to "substantial risk from fluctuations in market values ..."[10]

SOME DERIVATIVES ARE "SECURITIES" UNDER THE VOLCKER RULE AND ARE ELIGIBLE FOR THE LIQUIDITY MANAGEMENT EXCLUSION.

The Volcker Rule straightforwardly defines a security as having the same meaning as in Section 3(a)(10) of the Securities Exchange Act ("Exchange Act").[11] A total return swap ("TRS") is a contract linked to the performance of a reference entity. If that reference entity is a single security, or a narrow based security index, then the swap is a security-based swap ("SBS").[12] An SBS is a security as defined in Section 3(a)(10) of the Exchange Act, as amended by the Dodd-Frank Act.[13] As securities TRS that are SBS are eligible to be used by a banking entity under the liquidity management exclusion, so long as they meet the other listed criteria.

We note that the broader category of derivatives was not made eligible for the liquidity management exclusion. However, there are significant policy reasons why a smaller subset of derivatives should qualify. Many covered banking entities have been using TRS for liquidity management purposes for some time and there does not seem to be a policy reason why such entities should not continue to do so, provided they do so in accordance with the requirements of the Volcker Rule. The idea behind the liquidity management exclusion is to allow market participants to continue their historical liquidity management activities (subject to limitations that ensure it will not be abused). The Agencies also excluded repurchase agreements, reverse repurchase agreements and securities lending (transactions that are economically very similar to TRS and also frequently used to access liquidity) from the prohibition on proprietary trading.[14]

THEN DO TRS THAT ARE SBS COMPLY WITH THE REQUIREMENTS OF THE LIQUIDITY MANAGEMENT EXCLUSION?

Testing this proposition, we now attempt to apply the requirements of the liquidity management exclusion to a TRS that is an SBS. As noted above, use of the exclusion requires that a transaction be a purchase or sale of a security by a covered banking entity for the purpose of liquidity management in accordance with a documented liquidity management plan. The plan must:

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[9] *Id.*, at footnote 244 and accompanying discussion.
[10] *Id.*, at footnote 239 and accompanying discussion.
[11] 12 C.F.R. § 248.2(y).
[12] 77 Fed. Reg. 48264.
[13] 15 U.S.C. § 78c(a)(10). The Volcker Rule also defines a "derivative," and includes SBS in that definition. 12 C.F.R. § 248.2(h).
[14] 12 C.F.R. § 248.3(d)(1 and 2).

1. Specifically discuss and permit the amount, types, and risks of the TRS and the circumstances in which the TRS will be used;
2. Require that the purchase or sale of a TRS be principally for the purpose of managing the liquidity of the covered banking entity, and not be for the purpose of short-term price movements, whether for reasons of profit, arbitrage or hedging;
3. Require a TRS purchased or sold for liquidity management purposes be "highly liquid and limited to securities that the market, credit, and other risks of which the banking entity does not reasonably expect to give rise to appreciable" price movement;
4. Limit the TRS purchased or sold (together with other instruments purchased or sold) to an amount consistent with the covered banking entity's near-term funding needs;
5. Include the use of TRS in the covered banking entities' written policies and procedures and internal controls, as well as subject their use to independent compliance testing; and
6. Be otherwise consistent with the appropriate Agency's supervisory requirements.

Numbers 1, 5 and 6 above relate to the documentation of the use of TRS as part of a liquidity management plan. These criteria will be managed by the covered banking entity as part of its Volcker and general supervisory compliance programs.

Number 2 imposes a limitation on the use of any particular TRS as part of a liquidity management program. A covered banking entity may only claim use of the liquidity management exclusion for a TRS that is used "principally" for purposes of liquidity management. The purpose of this restriction is clear: to largely eliminate the ability of a covered banking entity to use a TRS to gain from price appreciation while claiming it was for liquidity management. This restriction applies equally, however, to non-TRS securities and will be made part of a covered banking entity's compliance program in order to carefully pre-check the intention of the entity prior to entering into any purchase or sale based on the liquidity management exclusion. In other words, there is nothing peculiar to this provision that would preclude the use of a TRS.

We reach the same conclusion regarding number 4, which would limit a TRS together with all other instruments to those necessary to satisfy the covered banking entity's near-term funding needs. A TRS may be included in this calculation in the same manner as any other security.

Number 3 requires that a TRS used for liquidity management purposes be "highly liquid" and not otherwise raise appreciable market, credit or other risks consistent with short-term price movements. The Volcker Rule does not define what "highly liquid" means, and the preamble to the Volcker Rule states that the "Agencies decline to identify particular types of securities that will be considered highly liquid

for purposes of the exclusion … in recognition that such a determination will depend on the facts and circumstances."[15] This language shows that the Agencies will look to the facts, circumstances and market functions surrounding each security to determine whether it is highly liquid.

There is precedent in several areas of financial institution law that test the nature of a highly liquid security. First and foremost are those securities that meet the test of a "high-quality liquid asset" under the liquidity coverage ratio ("LCR") adopted by certain agencies in 2014.[16] While TRS likely do not meet these restrictive standards, the Agencies failed to link qualifying under the LCR to use of the liquidity management exclusion. Therefore, a broader set of criteria will apply to highly liquid securities under the Volcker Rule.

Most analyses of the need for and use of highly liquid securities focus on the marketability of those instruments. Indeed, the most significant feature of a liquid instrument is the ability of the holder to turn that instrument into cash, especially during periods of market stress.[17] While a liquid market for an equity or a debt security is often characterized by the numbers of buyers and sellers ready to trade, liquidity in a TRS market could be shown by different factors, such as the ability of the covered banking entity to accelerate, terminate and close-out the TRS at its option, the absence of transfer restrictions in a TRS, and whether the reference entity of the TRS is itself a highly liquid security.

We believe that TRS can be structured to be "highly liquid" and will therefore satisfy the requirements to be used as part of a liquidity management plan consistent with the requirements of the Volcker Rule.

CONCLUSION

Under the plain language of the Volcker Rule, certain derivatives meet the definition of a security and are eligible to be used for liquidity management purposes. These derivatives will provide covered banking entities with additional liquidity options. We believe that the market will continue to develop SBS transactions that satisfy the requirements of the liquidity management exclusion of the Volcker Rule.

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[15] 79 Fed. Reg. 5555, at footnote 241.
[16] 79 Fed. Reg. 61529.
[17] See, e.g., http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/liquidity.pdf.

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