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How Dodd-Frank Rollback Changes The Volcker Rule

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The U.S. House of Representatives recently passed, and President Donald Trump signed into law, the Economic Growth, Regulatory Relief and Consumer Protection Act,[1] without any changes from the Senate version of the bill.[2] It represents the first significant deregulatory piece of legislation amending the Dodd-Frank Act.

The new law is wide-ranging and makes changes to a number of financial services laws,[3] including the Volcker Rule.[4] While the major provisions of the Volcker Rule remain unchanged, the new law makes three notable changes to (or affecting) the Volcker Rule: (1) an exemption for community banks, (2) increased opportunities to have funds and their investment advisers co-brand by sharing names, and (3) an expansion of the scope of the Section 3(c)(1) exemption of the Investment Company Act for small venture capital funds.

Community Bank Exemption

The new law creates a new exemption to the Volcker Rule's banking entity definition[5] for any bank or bank holding company with $10 billion or less in consolidated assets, so long as such banking entity's total trading assets or liabilities do not exceed 5 percent of the banking entity's total consolidated assets. This exemption not only permits community banks to engage in Volcker-prohibited activities such as proprietary trading and investments in covered funds[6] — though few community banks engaged in these activities at a significant scale even before the Volcker Rule — but would also exempt such community banks from having to maintain Volcker Rule compliance programs.[7] A community bank industry association has suggested that such compliance programs are an unnecessary and significant drain on bank resources.[8]

Co-Branding by Funds and Their Advisers Through Name Sharing

The new law also modifies the current prohibition on banking entities "sponsoring" covered funds by sharing the same name or a variation of the same name with a covered fund for corporate, marketing, promotional or other purposes.

The new law allows banking entities to share their names with covered funds, provided that:

- The banking entity in question is an investment adviser to the fund;
- The banking entity is not an insured depository institution, a company that controls an insured depository institution, or an entity treated as a bank holding company for purposes of the International Banking Act of 1978;
- The banking entity does not share the same name or a variation of the same name as any of the three categories of entity described in the bullet above; and
- The banking entity's name does not include the word "bank."

The impact of this change may be demonstrated through this illustration: A banking organization includes a subsidiary national bank, ABC NA, of a bank holding company, ABC Holdings. ABC Holdings has another subsidiary, outside the chain of ownership of ABC NA, that is an asset management firm called XYZ Capital Management. Under the new law, XYZ Capital Management may share all or part of its name with a fund — say, XYZ Fund I — that relies on Section 3(c)(1) or (7) of the Investment Company Act, if XYZ Capital Management is investment adviser to the fund. It was prohibited from doing so before the new law was passed, because XYZ Capital Management is a banking entity by virtue of being an affiliate of ABC Holdings and ABC NA, and because sharing a name with a covered fund constitutes prohibited "sponsorship" of that fund under the Volcker Rule.[9]

Expansion of 3(c)(1) Exemption: Not Volcker Rule Regulatory Relief for Certain Venture Capital Funds

The new law expands the scope of the exemption provided in Section 3(c)(1) of the Investment Company Act to allow certain small venture capital funds — those with no more than $10 million in aggregate capital contributions and uncalled committed capital — with no more than 250 investors (rather than the previous maximum of 100) to rely on the exemption. Because this change would expand the scope of the Section 3(c)(1) exemption from the Investment Company Act, any fund using this exemption would be a covered fund under the Volcker Rule.

Only the smallest venture capital funds can take advantage of the newly expanded Section 3(c)(1), given the $10 million cap, but any venture capital fund that does so should consider the fact that reliance on Section 3(c)(1) would make the venture capital fund a covered fund pursuant to the Volcker Rule.

The New Law Comes Up Short on Treasury's Recommended Volcker Regulatory Relief

The newly passed law should be viewed against the backdrop of the Trump administration's general push toward deregulation of the financial services industry. On Feb. 3, 2017, Trump issued an executive order that laid out core principles for U.S. financial regulation and required the U.S. Treasury Department to prepare a report or reports evaluating existing laws, regulations and policies for consistency with the core principles.[10] In response, on June 12, 2017, the Department of the Treasury issued a report, "A Financial System that Creates Economic Opportunities: Banks and Credit Unions."[11] Most of the report "evaluates the structure and effectiveness of portions of [the] Dodd-Frank [Act][[12]], relative to both its objectives and the nature of its implementation, which has unfolded for nearly seven years since enactment."[13]

With respect to the Volcker Rule, the report made 18 separate recommendations, of which it indicated

eight were the responsibility of Congress and 10 were the responsibility of the agencies with responsibility for the Volcker Rule.[14] Two of the eight recommendations for Congress from the report were included in the new law (the community bank exemption and the name sharing provision). The new law therefore is not inconsistent with the report, but does not go nearly as far as the report would have had Congress go. The report, for example, suggested that, among other things, Congress consider eliminating the purpose test from the Volcker Rule's proprietary trading definition, provide a way for banking entities to opt out of the "reasonably expected near-term demand" framework provided in the Volcker Rule's proprietary trading provisions, permit banking entity transactions with covered funds to the same extent as is permitted between banks and their affiliates pursuant to Section 23A of the Federal Reserve Act — that is, remove the "super" from "Super 23A" — and provide an exemption to the definition of "banking entity" for foreign funds that are not covered funds but that are controlled by a banking entity.

Conclusion

The new law represents the first significant item of legislation amending the Dodd-Frank Act. It makes several changes to the Volcker Rule, as described above, but to the extent that it provides regulatory relief in the context of the Volcker Rule, the new law's impact is likely to be modest, and with more importance for community banks than for most larger financial institutions.

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[1] S. 2155, as passed by Senate Mar. 14, 2018, https://www.congress.gov/bill/115th-congress/senate-bill/2155/text.

[2] See, e.g., Erica Werner, Trump signs law rolling back post-financial crisis banking rules, Washington Post (May 24, 2018), https://www.washingtonpost.com/business/economy/trump-signs-law-rolling-back-post-financial-crisis-banking-rules/2018/05/24/077e3aa8-5f6c-11e8-a4a4-c070ef53f315_story.html?utm_term=.9aaafee9ffe4; John Heltman, House reg relief vote now in sight, American Banker (May 15, 2018), https://www.americanbanker.com/news/house-reg-relief-vote-now-in-sight; Susan Cornwell and Katanga Johnson, House to take up Dodd-Frank rewrite 'soon,' says Speaker Ryan, Reuters (May 8, 2018), https://www.reuters.com/article/us-usa-house-ryan-banking/house-to-take-up-dodd-frank-rewrite-soon-says-speaker-ryan-idUSKBN1I92I7.

[3] The new law's provisions include, among others, (1) raising the threshold for enhanced prudential standards required under Dodd-Frank — the so-called "SIFI threshold" — from $50 billion to $250 billion; (2) reducing stress test requirements, (3) adjusting leverage and liquidity coverage ratio requirements, (4) exempting community banks from certain capital rules, (5) expanding the pool of

"qualified mortgages" under the Truth in Lending Act, (6) certain securities law changes designed to encourage capital formation, (7) instituting consumer protection measures regarding identity theft and data security, and (8) certain protections for borrowers and cosigners of student loans.

[4] Section 13 of the Bank Holding Company Act, codified at 12 U.S.C. § 1851. See 12 C.F.R. Part 248 (final regulations).

[5] Section 13(h)(1) of the Bank Holding Company Act, codified at 12 U.S.C. § 1851(h)(1). See 12 C.F.R. § 248.2(c).

[6] "Covered funds" — the Volcker Rule's term for certain investment funds with respect to which banking entities are restricted from investment, sponsorship, and certain transactions — include (1) funds that are not registered investment companies pursuant to exemptions contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act, (2) certain commodity pools under the Commodity Exchange Act, and (3), with respect to a banking entity that is or is controlled by a U.S. banking entity, non-U.S. funds that invest in securities for resale or other disposition or that otherwise trade in securities.

[7] 12 C.F.R. Part 248 Subpart D.

[8] The trade association, ICBA, said, in a letter to the Office of the Comptroller of the Currency:

In some instances, [community banks] have had to hire consultants and attorneys to figure out if they are even subject to the rule. For instance, even though bona fide hedging activities are considered exempt under the rule, community banks have had to hire consultants when engaging in interest rate swaps and other hedging activity to make sure that they comply with the rule. Community banks that routinely purchase and sell government securities and municipal securities have also had to use consultants to ensure that they are not technically engaging in proprietary trading under the definition of the rule.

Independent Community Bankers of America, Comment on Proprietary Trading and Certain Interest [sic] in and Relationships with Covered Funds (Volcker Rule) 12 CFR Part 44 (Docket ID OCC-2017-0014) (Sept. 19, 2017), https://www.icba.org/docs/default-source/icba/advocacy-documents/letters-to-regulators/2017/cl091917.pdf?sfvrsn=0.

[9] See 12 C.F.R. § 248.10(a)(1), 10(d)(9)(iii).

[10] Executive Order 13772, 82 Fed. Reg. 9965 (Feb. 3, 2017), https://www.gpo.gov/fdsys/pkg/FR-2017-02-08/pdf/2017-02762.pdf.

[11] Department of the Treasury, A Financial System that Creates Economic Opportunities: Banks and Credit Unions (June 2017), https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf.

[12] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank" or the "Dodd-Frank Act").

[13] Report at 32.

[14] Id. at 132-133.