Volcker 2.0 and the RENTD requirement…What's changed?

In 2017, Deloitte published "RENTD: The heart of the Volcker Rule",[1] which provided a comprehensive perspective on the RENTD regulatory construct and approaches to complying with this requirement. As the Agencies have now published proposed revisions[2] to the final implementing regulations[3], much attention has been directed toward understanding the implications of the new proposal and chief among them is the RENTD requirement.[4] Initial coverage of the proposed revisions focused on the increased flexibility and ease of compliance offered by the replacement of the demonstrable analysis standard with a risk-limit based presumption of compliance:

"The Agencies believe that this approach [limit based presumption of compliance] would allow for a clearer application of these exemptions, and would provide firms with more flexibility and certainty in conducting market making-related activities".[5]

[1] https://www2.deloitte.com/us/en/pages/risk/articles/rentd-heart-of-volcker-rule-summary.html

[2] Throughout this document, reference to the "proposed revisions" means the recently proposed changes to cited portions of 12 CFR Parts 44, 248, and 351 and 17 CFR Part 255 entitled, "Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds".

[3] Throughout this document, reference to the "Volcker Rule" and "Final Implementing Regulations" means the cited portions of 12 CFR Parts 44, 248, and 351 and 17 CFR Part 255, "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule"

[4] Its importance is reflected in proposed revisions by the fact that the Agencies have posed close of 30 questions with respect to RENTD limits and presumption of compliance for underwriting and market-making desks

[5] Supra note 2, page 108

While the proposed revisions may move the underwriting and market-making exemptions in this direction, the proposed change to a risk-limit approach to meeting the RENTD requirement retains many key structural features of the original implementing regulations and may result in continued uncertainty with regard to whether an organization is conducting its market-making and underwriting activities in a manner consistent with each exemption's compliance requirements. In particular, the rebuttable presumption of compliance requires that limits be ***designed*** not to exceed RENTD of customers, clients and counterparties (CCCs) and then tasks the Agencies with assessing that design.[6] The remainder of this paper takes a deeper look at this new rebuttable presumption of compliance and asks a simple question, "How might Agencies assess design of the risk limits?"

The rebuttable presumption of compliance

In the 2013 implementing regulations, an underwriting or market-making trading desk's transactions are considered proprietary trading and the burden was on the trading desk to prove its trading activities were permissible under the applicable exemption. Part of the compliance program for each trading desk involved the setting of risk limits related to RENTD, but staying within the limits did not necessarily prove compliance. Under the proposed revisions, the presumption assumes desk transactions are permissible if the desk stays within the risk limits. Even with the rebuttable presumption of compliance, however, trading desks are still required to adhere to permissible activity, even when trading within risk limits.[7]

Both the underwriting and market-making exemptions in the proposed revisions are structured similarly with regard to RENTD and its relationship to the rebuttable presumption of risk limit compliance. In implementation, the specific limits for underwriting and market-making differ,[8] [9] but the principle of design alignment with RENTD is the same in both cases. Using market-making as the example case, the proposed revision states:

"In particular, the proposal would provide that the purchase or sale of a financial instrument by a banking entity shall be presumed to be designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, based on the liquidity, maturity, and depth of the market for the relevant types of financial instrument, if the banking entity establishes internal risk limits for each trading desk, **subject to certain conditions**, and implements, maintains, and enforces those limits, such that the risk of the financial instruments held by the trading desk does not exceed such limits.."[10] [emphasis added]

The key phrase in this excerpt is "subject to certain conditions," since it means that risk limits must be set in accordance with some standard. This is important because in the original 2013 rule, this standard was the "demonstrable analysis" required to show that trading activities and limits were set in a manner consistent with RENTD. Instead, the Agencies now state that:

"As noted, a banking entity would not be required to adhere to any specific, pre-defined requirements for the limit-setting process beyond the banking entity's own ongoing and internal assessment of the amount of activity that is required to conduct market making activity, including to reflect the banking entity's ongoing and internal assessment of the reasonably expected near term demands of clients, customers, or counterparties."[11]

Hence, there will not be specific analytical requirements under the proposed approach, but instead the general premise that a banking entity's "own ongoing and internal assessment" would provide a basis to conduct its market-making (and underwriting) activities in a manner consistent with its expectations for RENTD. While conveying greater flexibility to banking entity's to determine how to set limits that align with RENTD, the Agencies also are quick to state that the limit setting process will be subject to supervisory

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[6] See §_.4(a)(8)(ii) and §_.4(b)(6)(ii) of the proposed revisions to the text of the rule

[7] Supra note 2, page 110

[8] Underwriting trading desks are required to set risk limits related to its (1) Amount, types and risk of its underwriting position, (2) level of exposures to relevant risk factors arising from its underwriting position, and (3) period of time a security may be held. See §_.4(a)(8)(i)(B).

[9] Market-making trading desks are required to set risk limits related to the (1) amount, types and risk of its market-maker position, (2) amount, types and risk of products, instruments, and exposures the trading desk may use for risk management purposes, (3) level of exposures to relevant risk factors arising from its financial exposure, and (4) period of time a financial instrument may be held. See §_.4(b)(6)(i)(B).

[10] Supra note 2, pages 107-108

[11] Supra note 2, page 109

review and oversight[12] and that any breaches and temporary or permanent increases of the limits must be "promptly" reported to the applicable Agency(ies).[13]

The design emphasis

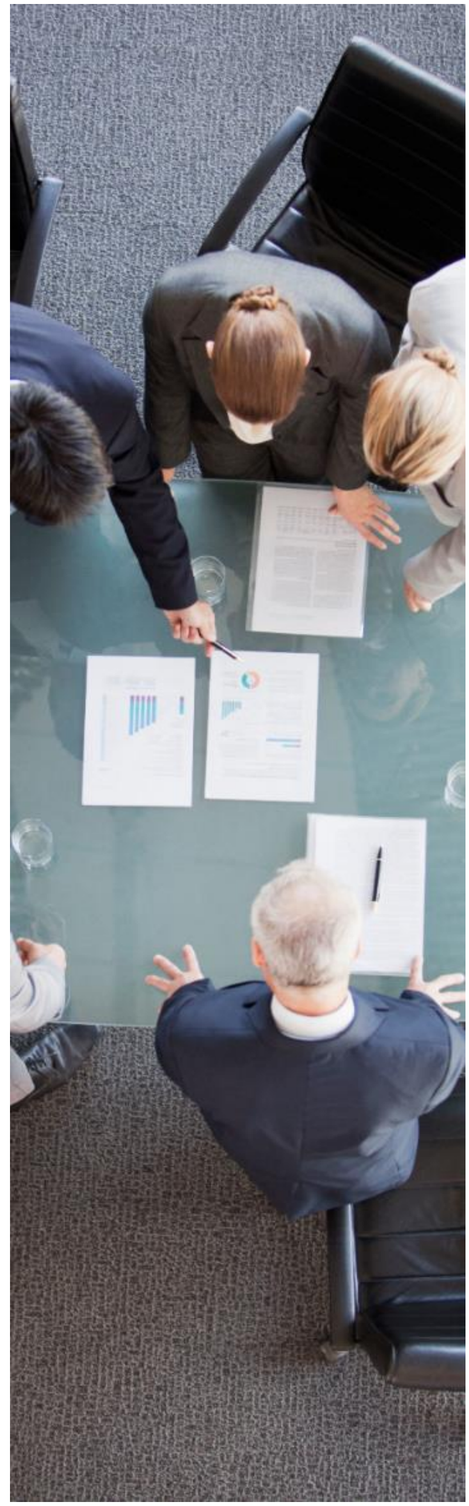
In contrast to the 2013 final implementing regulations, which relied on demonstrable analysis to explicitly show how the RENTD related limits were set, the proposed revision requires that the risk limits underpinning the rebuttable presumption of compliance be designed not to exceed RENTD. The Agencies are then required, through the supervisory process, to assess that design to determine whether it meets the statutory RENTD requirement. The Agencies would presumably assess the design by reviewing the "policies and procedures for setting and reviewing risk limits"[14] and then deciding whether those limits are consistent with RENTD. The proposed revisions include questions regarding how limits should be set as well as how the Agencies should think about assessing them.

The supplemental information accompanying the proposed revisions offer some additional insight into the expectations about the nature of these limits by reference to "risk and position limits" in footnote 115. The footnote states that the Agencies believe that existing risk and position limits put in place in response to Appendix A metric requirements in the original 2013 rule can help manage and monitor market-making activities. Within the context of complying with the RENTD requirement, this reference would seem to imply the risk and position based limits already in place and reported to the Agencies could serve to meet the limit requirements for the proposed rebuttable presumption of compliance.

Observations on the proposed approach

Removal of the demonstrable analysis requirement is intended to provide additional flexibility and lighten the burden of compliance, particularly for banking entities with Moderate trading assets and liabilities. However, the jury is still out on whether the proposed revisions will achieve their stated objective. As noted above, our view is that the proposed revisions might actually create greater uncertainty, and the heightened expectations with regard to reporting of limit breaches and increases could make the burden of demonstrating risk limit alignment with RENTD more demanding, not less.

While viewed as burdensome, demonstrable analysis of historic customer transactions remains an understandable, observable, auditable and data driven input into the RENTD analysis. Firms may struggle to find a suitable substitute and may ultimately continue to rely on the systems and processes already built for compliance with the 2013 rule. The remainder of this document looks first at the structural features of the proposed revision and highlights key areas that have not changed from the original 2013 implementing regulations, and then turns attention to specific aspects of the new approach that could present areas of greater uncertainty and potential burden.



[12] Supra note 2, page 110

[13] Supra note 2, page 109

[14] Supra note 2, page 109

Features related to RENTD that have not changed

There are several key aspects of the proposed RENTD construct that have not meaningfully changed from the original 2013 implementing regulations and which represent significant drivers of the compliance burden. First, and foremost, is the presence of the RENTD requirement itself in the proposed revisions. This is not surprise because the RENTD requirement is written into the original statutory language of section 1851 of the Bank Holding Company Act:

"The purchase, sale, acquisition, or disposition of securities and other instruments described in subsection (h)(4) in connection with underwriting or market-making-related activities, to the extent that any such activities permitted by this subparagraph are designed not to exceed the **reasonably expected near term demands of clients, customers, or counterparties**." [15] [emphasis added]

As a statutory requirement included in the original text of the law, the RENTD construct will remain a binding requirement of any implementing regulations until the statute itself is rewritten. Hence, all underwriting and market-making trading activities will have to reconcile back to this foundational requirement. In practice, it is not easy to work around the RENTD requirement, particularly because of the way that CCCs are defined. As in the original implementing regulations, CCCs are still considered third parties with less than $50 billion in trading assets and liabilities in the proposed revisions.[16] Taken together, the core statutory RENTD requirement and the definition used to segregate trading activities between CCCs and non-CCCs (NCCCs) create constraints on underwriting and market-making activities because trading desk risk limits are anchored on RENTD.

In addition to the core RENTD construct and CCC definition, the risk limits that must be set and monitored to demonstrate compliance with RENTD remain the same in the proposed revision. This is important for a number of reasons. First, experience with the original implementing regulations has shown that most trading desks have not historically looked at their risks and positions using the sub-portfolios required by the Volcker Rule. For market-making trading desks, there has been general alignment at the Financial Exposure (FE) level where Market-Making Inventory (MMI) and Risk Management Inventory (RMI) positions are blended together to calculate the net risk exposure of the trading desk. The situation is the same with Holding Period limits, which, for securities trading desks, have largely aligned with inventory aging frameworks.[17]

With regard to MMI and RMI sub-portfolios, however, market-making trading desks had not historically segregated their trade populations in this manner prior to the 2013 implementing regulations and in many cases, these limits were implemented as "Volcker Limits" and not risk and position limits that were reported as part of the Appendix A submissions. This is important because the continued requirement to implement MMI and RMI limits for each underwriting and market-making trading desk means that all of the historical challenges of retro-fitting these data attributes onto the transaction portfolio will continue to exist if banking entities have not modified their core trade capture and processing systems to set these flags at the time the trades are executed and booked.[18] [19]

Moreover, the largest portion of the demonstrable analysis that underpins limit setting for MMI and RMI involved recasting historical position and risk exposure data into MMI-CCC, MMI-NCCC and RMI sub-portfolios. Therefore, to the extent banking entities decide to continue using current methodologies as a way to explain the design of their limit setting process to the Agencies, these challenges will remain. An obvious question that immediately arises, then, is whether a banking entity would choose to adopt an alternative method and if so, how defendable would it be in comparison to the higher standard that previously existed? This would be particularly true for larger firms that have significantly invested in their infrastructure to comply with the original 2013 final rule.

Taken in total, these core features of the RENTD regulatory construct have not changed in the proposed revision to the Volcker Rule. As discussed further below, the lack of meaningful change in these areas limits the relief that can be achieved in light of other newly proposed features of the compliance framework.

[15] 12 USC §1851 at (d)(1)(B)

[16] Largely viewed as the "Big 9" dealers in practice

[17] As noted in the proposed revision, inventory aging as a concept for derivatives oriented trading desks has proven to be not meaningful in terms of monitoring for impermissible proprietary trading activities.

[18] This of course pre-supposes that a banking entity's internal "policies and procedures" would include looking at historical trading activity as a basis to analyze and set MMI and RMI limits.

[19] These operational issues were covered in more detail in "RENTD: The heart of the Volcker Rule", section 4.2

New wrinkles to the RENTD requirement

There were a few new features presented in the proposed revisions—the main being the ability to presume compliance by staying within risk limits that were set using the firm's own "internal analyses and processes." The table shown below summarizes four significant changes related to the RENTD requirement that have the potential to present compliance uncertainty and/or increased burden in our view. At a minimum, these issues ought to give most banking entities with Moderate trading assets and liabilities pause before they begin scaling back their compliance programs.

Feature	Description	Possible implication
Coverage of the Rebuttable Presumption	Banking entities with Significant and Moderate trading assets and liabilities can avail themselves of the limit-based rebuttable presumption of compliance	Moderate firms are not required to use this approach, but it is the path of least resistance as most already have set RENTD related limits and would have to develop alternative approaches to demonstrating compliance for most trading desks
Replacement of the Short-Term Intent Prong	The third prong of the trading account definition will be based on fair value measurement instead of short term intent	Using fair value measurement as the criteria may result in more financial instruments being scoped into proprietary trading which has potential implications on traded desk design and population—i.e., there may be more areas that need to comply
"Harder" Risk Limits	Banking entities must "promptly" report breaches of risk limits as well as permanent and temporary limit increases	Prior limits were "softer" in that breaches were dealt with internally as a matter of Volcker monitoring and governance—the proposed requirement to report each breach and limit increase to the Agencies will heighten the rigor that most firms will want to apply to ensure the limit setting approach is defensible
CEO Attestation	CEO attestation is required for all banking entities having Significant and Moderate trading assets and liabilities which is different than the basis this requirement was set on in the original implementing regulations	CEO attestation has significant ramifications for banking entities in the Moderate category as the requirement to formally attest to the design of the compliance framework will mean that a basis to make that assertion be present—this suggests a level of compliance program formality more akin to the original regulatory requirements

Each of these new changes in the proposed revisions represent areas where compliance burdens may remain the same, decrease and, in some cases, increase for banking entities with Significant and Moderate trading assets and liabilities. The case is more acute for banking entities with Moderate trading assets and liabilities because one of the main headlines with the proposed revisions is "relief for smaller firms" and a more "tailored" approach that is aligned with the complexity and operating scale of these firms:

"In particular, the Agencies aim to further reduce compliance obligations for small and mid-sized firms that do not have large trading operations and therefore reduce costs and uncertainty faced by smaller and mid-size firms in complying with the final rule, relative to their amount of trading activity."[20]

As the saying goes, however, "the big print giveth and the small print taketh away." The main mechanism to reducing the compliance obligations appears in Subpart D where Moderate banking entities are now able to demonstrate compliance by making suitable reference to the Volcker Rule in its existing policies and procedures. This is a step down for many banking entities that were required to establish the full "6-pillar" compliance program under the original implementing regulations. While this would appear to offer significant benefit to banking entities with Moderate trading assets and liabilities, our view is that the requirement for these banking entities to continue to provide a CEO attestation annually as well as the burden of demonstrating effective "design" of the RENTD related risk limits will mitigate this benefit, at least to some extent.

[20] Supra note 2, pages 17-18

The CEO attestation requirement for Moderate banking entities means there will need to be a basis to make the annual assertion. Most of these banking entities have already implemented a compliance program aligned with the original 2013 rule, so widespread restructuring of the existing compliance programs would need to be carefully considered in light of the need to continue attesting that an effectively designed compliance program is in place. One of the areas where this is likely to be acutely felt is the risk limit setting process where there will be a need to ensure these limits are based on a defensible methodology.

Given the heightened transparency with the Agencies on limit breaches and increases, there is also likely to be some hesitancy to adopt a less formal and rigorous approach than the old demonstrable analysis standard. After all, risk limits must be designed to align with RENTD. How will CEOs attest compliance has been achieved if there are numerous breaches throughout the year? Our view is that this will create some internal tensions in many banking entities because the inherent desire will be to set the limits as high as possible, but the higher they are set, the greater the risk that the Agencies find fault with the "policies and procedures" used to set the risk limits. Without the clarity of the demonstrable analysis standard, the path of least resistance would appear to be to retain the more rigorous historical approaches for trading desks with reasonable amounts of data available and established processes. Adoption of alternative methods could be employed in situations where the overall RENTD construct does not fit a specific trading desk well.[21]

These considerations lead back to the same basic questions, namely "how will Agencies assess the design of the risk limit setting process?" and "what methods will be employed to judge whether a specific risk limit is aligned with RENTD?" In general, data driven methodologies and approaches to limit setting are replicable and offer the opportunity to more clearly demonstrate how limits have been set when compared to purely qualitative approaches. Moreover, substantial effort and resources have already been dedicated to building the infrastructure to support the calculation of RENTD, limit setting, monitoring and reporting. Setting these investments aside to pursue less formal approaches may not be palatable given the CEO attestation requirement and the need to clearly demonstrate the linkage between risk limits and RENTD to the Agencies. Without the clarity of the demonstrable analysis standard, banking entities will be left to manage the uncertainty of how the Agencies will assess their limit setting policies and procedures unless further clarity is provided in subsequent proposals.

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[21] For example, if a business has decided to launch a new market-making trading desk, there may be no historical information available to work with so a new approach may need to be utilized to set the initial limits.

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