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Volcker Rule: Community Bank Exemption

On July 9, 2019, the Board of Governors of the Federal Reserve System (the "FRB"), U.S. Commodity Futures Trading Commission, Federal Deposit Insurance Corporation (the "FDIC"), Office of the Comptroller of the Currency (the "OCC"), and U.S. Securities and Exchange Commission (collectively, the "Federal Agencies") issued a final rule (the "Final Rule") to exempt community banks from the Federal Agencies' regulations implementing the prohibitions and restrictions on proprietary trading and the sponsoring and investment in hedge funds and private equity funds ("Volcker Rule").

Background

The Volcker Rule, adopted by the Federal Agencies pursuant to Section 13 of the Bank Holding Company Act of 1956 (the "BHCA"), generally prohibits any "banking entity" from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund, subject to certain exemptions. Under Section 13 of the BHCA, the definition of "banking entity" includes any insured depository institution, as defined under the Federal Deposit Insurance Act, any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of such entity (excluding from the term "insured depository institution" certain insured depository institutions that function solely in a trust or fiduciary capacity).

Upon the enactment of the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "EGRRCPA") on May 24, 2018, Section 13 of the BHCA was modified by revising the definition of "banking entity" to exclude certain community banks and their affiliates from the Volcker Rule restrictions. Specifically, the term "insured depository institution" was amended to exclude any institution that does not have, and is not controlled by a company that has: (i) more than $10 billion in total consolidated assets; and (ii) total trading assets and trading liabilities exceeding five percent (5%) of total consolidated assets. As a result, an insured depository institution is not a "banking entity," and thus is not subject to the Volcker Rule, if the insured depository institution, and each entity that controls it, meets the statutory exemption. The EGRRCPA also amended the Volcker Rule's name-sharing restrictions to generally permit a hedge fund or private equity fund that is organized and offered by a banking entity to share the same name or variation of the same name as a banking entity that is an investment adviser to the fund, subject to certain limitations as noted below.

The Final Rule's sole purpose is to conform the Volcker Rule to the EGRRCPA's amendments to Section 13 of the BHCA.

Community Bank Exemption

Consistent with the EGRRCPA, the Final Rule modifies the definition of an "insured depository institution." In so doing, an insured depository institution is excluded from the Volcker Rule restrictions if it, and every entity that controls it, satisfies both of the following:

- has total consolidated assets equal to or less than $10 billion; and
- has total consolidated trading assets and trading liabilities equal to or less than five percent (5%) of its total consolidated assets.

This exemption is not available to either (i) foreign banking organizations with a U.S. branch or agency or (ii) investors that control industrial loan companies. Such entities remain subject to the Volcker Rule restrictions.

In determining eligibility for this exemption from the Volcker Rule, the insured depository institution and bank holding company may rely upon its most recent *Consolidated Report of Condition and Income* or *FR Y-9C*, respectively, as the source of data for its consolidated assets and its trading assets and liabilities.

Name-Sharing Exemption

The Final Rule also modifies the Volcker Rule's name-sharing restrictions. Pursuant to this change, a hedge fund or private equity fund sponsored by a banking entity that is an investment adviser to the fund is permitted to share the same name or a variation of the same name with such banking entity, subject to certain conditions. Specifically, these conditions require that the investment adviser is not, and does not share the same name (or a variation of the same name) as, an insured depository institution, a company that controls an insured depository institution, or a company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act, and that the investment adviser's name does not contain the word "bank."

What Does This Mean for Your Institution?

Prior to July 21, 2015, the date by which applicable institutions were required to comply with the requirements of the Volcker Rule, few community banks engaged in proprietary trading activities and/or sponsored or invested in hedge funds and/or private equity funds. At that time, most community banks limited their proprietary trading and investment activities to U.S. government, agency, municipal obligations and certain other liquidity management activities, each of which are specifically exempted from the Volcker Rule's prohibitions. Thus, at the outset, the Volcker Rule's impact on the community banking industry was not as substantial as it was on larger banking organizations.

In December 2013, providing a level of relief to community banks, the FRB, OCC and FDIC issued guidance indicating that community banks with assets under $10 billion that engage in proprietary trading or that sponsor or invest in hedge funds and/or private equity funds may satisfy the Volcker Rule compliance program requirements by enhancing existing policies (as opposed to creating a new and substantially more burdensome compliance program). While the guidance was welcome news to many, community banks remained indifferent, as most of these smaller institutions do not engage in the trading and investing activity prohibited by the Volcker Rule, and the sheer complexity of the rule is enough to dampen any appetite for proprietary trading and investing in covered funds for those community banks who are looking to expand their trading and investment activities.

Now, the Final Rule's exemptions provide eligible community banks with an opportunity to diversify, to a small degree, their investment portfolios.

Importantly, for those community banks who now choose to engage in proprietary trading or sponsoring or investing in hedge funds or private equity funds, they should remain vigilant in reviewing and tracking asset levels to determine their eligibility for continuing relief under the Final Rule. The Federal Agencies, as part of their on-going supervisory examination process, will review

whether a banking organization, and each of its affiliates and subsidiaries, that engaged in these activities are actually exempt under the Final Rule.

To view the full text of the Final Rule, click here.

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