

# VOLCKER PROP TRADING PROVISIONS: HOW FIRMS ARE PREPARING



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The July 21 Volcker rule compliance date is approaching rapidly. While most affected firms have completed the year-plus long process of analyzing their activities in light of the rule's restrictions, most are still putting the finishing touches to their compliance programs.

In this article, we describe trends we are seeing in these final weeks of preparation, focusing on the compliance program required by the Volcker rule's proprietary trading restrictions. We have organized our comments around what have become known as the "pillars" of Volcker rule compliance—written policies and procedures; internal controls; corporate governance; independent testing and audit; training; recordkeeping; and CEO attestation.

In the next issue of *Compliance Reporter*, our colleagues will provide similar insights relating to preparation for compliance with the Volcker rule's covered fund provisions.

## WRITTEN POLICIES AND PROCEDURES

A Volcker rule compliance program must include written policies and procedures reasonably designed to document, describe, monitor and limit covered trading activities, including setting, monitoring and managing required limits conducted by the firm in order to ensure that all activities subject to the Volcker rule are conducted in compliance with the rule.

Many firms are taking a multi-level approach to policies and procedures. For example, a typical approach is a three-tiered documentation structure: Tier 1 includes a board-level policy or other similar board-approved document; Tier 2 includes an enterprise-wide compliance manual or policy; and Tier 3 includes desk- or business-level policies and procedures.

As July 21 approaches, the main focus with respect to written policies and procedures appears to be on:

- Finalizing and implementing board-level policies and presenting these policies to the board or board committees for approval;
- Summarizing the Volcker rule compliance program in a document to be approved by the board or board committee before July 21;
- Finalizing and implementing enterprise-wide Volcker compliance manuals and obtaining approvals or acknowledgements from the appropriate front office personnel, control functions and senior management;
- Finalizing and implementing trading desk-level

el policies and procedures and trading mandates that govern the activities of a trading desk engaged in exempt or excluded trading under the proprietary trading provisions—the most difficult examples of this include procedures to calculate the reasonably expected near-term demand for clients, customers or counterparties, or RENTD, for underwriting or market making and correlation analysis for risk-mitigating hedging;

- Drafting written supervisory procedures for trading desk supervisors and business line managers, which include processes to review trading desks' requests for exceptions to limits or policies; and
- Drafting new or enhancing existing escalation policies and procedures to incorporate the Volcker rule.

## INTERNAL CONTROLS

A Volcker rule compliance program must contain a system of internal controls reasonably designed to monitor compliance and prevent the occurrence of prohibited activities.

Many firms are finding the most difficult aspect of developing such controls to be "proving the negative"—demonstrating to regulators that they are *not* engaging in trading activities that would violate the proprietary trading provisions. As July 21 approaches, many firms are in the process of:

- Establishing, implementing and enforcing limits for each trading desk, including with respect to RENTD;
- Conducting a gap analysis of risk and other limits for each trading desk to determine where limits might need to be newly created or enhanced by July 21;
- Finalizing escalation and remediation processes for when a potential or actual violation of the Volcker rule has been identified, including determining the appropriate chain of escalation within the firm and, potentially, to relevant Volcker rule regulators;
- Developing reporting mechanisms for senior management reports to the board or board committees;
- Modifying existing mechanisms for calculating and reporting metrics to the Volcker rule regulators for first-wave metrics reporters, or developing and testing these mechanisms in advance of the metrics reporting date for second- and third-wave metrics reporters; and
- Developing, in conjunction with industry efforts, a process to send or receive representations to determine whether a counterparty

is a "U.S. entity" for purposes of the foreign bank exemption—otherwise known as the TOTUS exemption—and, if so, whether one of the exemptions from the TOTUS prohibition on transacting "with" or "through" a U.S. entity is available.

## CORPORATE GOVERNANCE

A Volcker rule compliance program must set forth a management framework that clearly delineates responsibility and accountability for compliance and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified by the Volcker rule or management as requiring attention.

Boards and board committees, as well as senior management, appear to be more directly involved in the details of Volcker rule compliance than is typical in connection with oversight of other topics relating to banking or trading regulation. We suspect this is a result of the spotlight that regulators and politicians have placed on the Volcker rule.

Many firms are providing their boards and board committees with presentations or reports that contain a surprising amount of detail about the Volcker compliance program. This appears to be consistent with the expectations of regulators. As July 21 approaches, many firms are working hard to create these detailed documents.

Additionally, we have seen that many firms are in the process of:

- Finalizing the allocation of responsibilities between the board and board committees;
- Finalizing the definition of "senior management," including determining whether senior management responsibilities will be fulfilled by allocating responsibilities to enterprise-wide and business-specific Volcker committees, steering groups or forums comprised of senior members of the front office and relevant control functions that act as the second and third lines of defense, including risk, compliance, legal, audit or finance;
- Determining how frequently the board or board committee will review the Volcker compliance program and any related Volcker compliance issues, which appears for most to be quarterly or semi-annually; and
- Allocating responsibilities among the various control functions and the front office to determine who is responsible for:
  - ▶ Testing and auditing the Volcker compliance program;

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REGULATOR	REGION	TOPIC	DETAILS	DEADLINE
CSA	North America	Venture issuers	The CSA announced final implementation of amendments to streamline disclosure by venture issuers.	Becomes effective June 30.
CSA	North America	Oil, gas disclosures	The CSA introduced amendments to Instrument 51-101 related to disclosure of reporting issues in the oil and gas industry.	Becomes effective July 1.
FINRA	North America	Swaps	The SEC has approved a proposal from FINRA to adopt NASD Rule 3010(e) (Qualifications Investigated), relating to background checks on registration applicants, as FINRA Rule 3110(e).	Becomes effective July 1.
FINRA	North America	Educational communication	FINRA is proposing a rule that would require a member firm that hires or associates with a registered representative to provide an educational communication to certain former retail customers.	Comments due July 2.
SEC	North America	Pay versus performance	The SEC has proposed an amendment to Item 402 of Regulation S-K that would adopt rules requiring registrants to disclose the relationship between executive compensation paid and financial performance.	Comments due July 6.
European Securities and Markets Authority	Europe	Virtual currency	ESMA is seeking evidence on investments using virtual currency or distributed ledger technology and has called for information from stakeholders.	Comments due July 21.
FINRA	North America	Exam program	FINRA is seeking comment on a proposal to restructure the representative-level qualification exam program so that all potential representative-level registrants would take a general knowledge examination and an appropriate specialized knowledge exam to reflect their particular registered role.	Comments due July 27.

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- ▶ Overseeing the implementation of the Volcker compliance program, including responsibility for Volcker manuals, policies, procedures and trading mandates;
- ▶ Overseeing the CEO attestation and sub-certification process;
- ▶ Training all relevant personnel and managers on the Volcker rule and Volcker compliance program;
- ▶ Setting, revising, approving, reviewing, amending and testing limits and models used to identify, value and monitor risks of trading activities; and
- ▶ Monitoring for compliance with the back-stop prohibitions.

### INDEPENDENT TESTING AND AUDIT

A Volcker compliance program must provide for independent testing and audit of the effectiveness of the program conducted periodically by qualified internal personnel or a qualified outside party.

Testing and audit teams are preparing for this new requirement by:

- Determining how to prioritize the order of testing of various elements of the compliance program;
- Incorporating into their existing annual testing and audit plans the particular areas under the Volcker rule that will be tested and audited on a periodic basis and determining how often such tests and audits will need to occur; and
- Determining whether the tests or audits will include a risk-based approach or a rule-based approach, or a combination of the two.

### TRAINING

A Volcker compliance program must provide for training of appropriate personnel and managers to implement and enforce the compliance program effectively.

Most firms are in the process of finalizing their training materials to train their board and board committees, senior management and all other employees with the goal of having all relevant directors and employees trained before July 21. Training can take a number of different forms. However, we have seen several firms settle on an approach that includes:

- In-person presentations to the board or board committees regarding the Volcker rule, Volcker compliance program and their related board or board committee responsibilities;
- High-level Volcker training for all employees worldwide, usually via an online training module with assessment questions; and
- Detailed, targeted training for employees who are most impacted by the Volcker rule because of their roles on trading desks, usually via a combination of an online training module with assessment questions followed by more specific, in-person training by relevant supervisors and business-line managers.

### RECORDKEEPING

A Volcker compliance program must provide for the creation and retention of records sufficient to demonstrate compliance with the Volcker rule. These records must be retained for at least five years—or longer if required by regulators—and provided to such agencies upon request.

Many firms are in the process of ensuring that their existing recordkeeping systems are capable of storing and maintaining all of the required records under the proprietary trading provisions and Appendix B, if applicable, for a minimum of five years in an appropriate manner and format.

### CEO ATTESTATION

The CEO of a firm subject to the Appendix B enhanced compliance program must attest annually in writing to the firm's primary Volcker rule regulators that the firm has in place processes to establish, maintain, enforce, review, test and modify the compliance program in a manner reasonably designed to achieve compliance with the rule. This attestation may be provided, for U.S. branches or agencies of foreign banking entities, for the entire U.S. operations of the foreign banking entity by the senior management officer of the U.S. operations who is located in the U.S.

For firms subject to Appendix B, the first CEO attestation must be filed by March 31, 2016. In preparation, many firms are in the process of developing a CEO attestation process that includes sub-certifications, often modeled on Sarbanes-Oxley Act attestations. Foreign firms are also in the process of determining who will make their attestation, which is particularly difficult in light of continuing regulatory uncertainty regarding the scope of the attestation for foreign banks.

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