Volcker Rule: Compliance Program, Reporting and Recordkeeping Requirements

Jan. 23, 2014

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On December 10, 2013, the U.S. federal banking agencies,[1] the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission (the "CFTC," and, together with the federal banking agencies and the SEC, the "Agencies") jointly adopted regulations (the "Final Regulations") to implement Section 619 of the Dodd-Frank Act, commonly known as the Volcker Rule.[2] The Final Regulations were adopted more than two years after proposed regulations to implement the Volcker Rule (the "Proposed Regulations") were first published.[3]

The Volcker Rule prohibits any "banking entity" from (i) engaging in proprietary trading and (ii) acquiring and retaining an ownership interest in, sponsoring or having certain relationships with hedge funds, private equity funds and certain other private funds ("covered funds"), subject to certain exemptions.

In this Alert, we discuss the Volcker Rule's compliance program, reporting, and recordkeeping requirements. The Final Regulations, in Subpart D, require banking entities that are subject to the Volcker Rule to implement internal controls and compliance programs reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading and covered fund activities and investments. [4] The required scope of the compliance program will vary depending on the size of the banking entity and the nature of the activities or investments. In a change from the proposed rule, a banking entity that does not engage in any covered activities or investments need not establish a compliance program unless it becomes engaged in such activities. [5] The chart below details the extent to which a banking entity that engages in covered activities must establish a compliance program.

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[1] The U.S. federal banking agencies are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System (the "FRB"), and the Federal Deposit Insurance Corporation (the "FDIC").

[2] The Final Regulations and accompanying statements, fact sheets, and related documents can be found on the websites of the Agencies. For example, they are available on the FRB's website at http://www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm.

[3] For a summary of the Proposed Regulations, *see* Proposed Volcker Rule Regulations: A Summary (Oct. 18, 2011). The Proposed Regulations can be found in the Federal Register at 76 FR 68846 (Nov. 7, 2011) and on the FRB's website at http://www.federalreserve.gov/newsevents/press/bcreg/20111011a.htm.

[4] Final Regulations § ___.20(a).

[5] Final Regulations § ___.20(f)(1).

Bank Entity by Total Size[6] and Activity	Compliance Requirement	Effective Date
<$10 billion + any covered activity[7]	May reference Volcker Rule compliance measures in existing compliance program	As soon as practicable or July 21, 2015.
$10 billion to $50 billion + any covered activity[8]	New compliance program must include six core elements	As soon as practicable or July 21, 2015.
$10 billion to $25 billion[9] + proprietary trading under subpart B of the Rule + subject to trade reporting under Appendix A[10]	New compliance program must include six core elements + enhanced Appendix B requirements[11]	As soon as practicable or December 31, 2016.
$25 billion to $50 billion[12] + proprietary trading under subpart B of the Rule + subject to trade reporting under Appendix A[13]	New compliance program must include six core elements + enhanced Appendix B requirements	As soon as practicable or April 30, 2016.
$50 billion[14] + any covered activity[15]	New compliance program using six core elements + enhanced Appendix B requirements	As soon as practicable or July 21, 2015.
Any banking entity notified by its primary federal supervisory agency in writing[16]	Must satisfy enhanced Appendix B requirements or trade reporting under Appendix A or any standard imposed by the agency	Varies by notice

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[6] Measured by total assets and liabilities. Foreign banking entities with U.S. operations only consider U.S. operations when calculating total assets and liabilities.
[7] Final Regulations § ___.20(f)(2).
[8] Final Regulations § ___.20(b).
[9] Excluding proprietary trading assets and liabilities involving U.S. government or agency obligations.
[10] Final Regulations § ___.20(c)-(d). *See* Reporting and Recordkeeping Requirements section below.
[11] The Agencies jettisoned Appendix B of the proposed rules but retained Appendix C enhanced requirements of the proposed rules, which now constitute Appendix B.
[12] Excluding proprietary trading assets and liabilities involving U.S. government or agency obligations.
[13] Final Regulations § ___.20(c)-(d). *See* Reporting and Recordkeeping Requirements section below.
[14] Excluding proprietary trading assets and liabilities involving U.S. government or agency obligations.
[15] Final Regulations § ___.20(c)(2).
[16] Final Regulations § ___.20(c)(3); (d)(1)(iii).

The Final Regulations articulate six core elements of a mandated compliance program:

- Internal written policies and procedures that document, describe and monitor covered activities to ensure compliance with the Final Regulations;
- Internal control systems designed to monitor and identify potential areas of noncompliance and to prevent prohibited activities;
- A management framework that delineates responsibility and accountability for compliance with trading limits, strategies, hedging activities, investments, incentive compensation, and other matters in the Final Regulations;
- Independent testing for the effectiveness of the compliance program;
- Training for trading personnel and managers to implement and enforce the compliance program; and
- Recordkeeping to demonstrate compliance, which the banking entity must provide upon request and retain for at least five years.[17]

Firms should be aware that some particular elements of the compliance program requirements have been folded into the specific proprietary trading and covered funds sections of the Final Regulations. For instance, a banking entity that operates under the market making exemption for proprietary trading must, as a part of the requirements under the exemption, establish internal controls and procedures reasonably designed to address:

- The financial instruments that each trading desk purchases and sells;
- The products, instruments, exposures, techniques, strategies, and personnel involved to manage the risks of market making;
- Limits for each trading desk based on the amount, types, and risks related to its inventory, the amount of exposure created by the activity, and length of time financial instruments may be held; and
- Authorization procedures to exceed limits imposed by the Final Regulations.[18]

Banking entities are expected to tailor their compliance programs to specific covered activities and the exemptions on which they rely. For instance, a banking entity relying on the covered funds

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[17] Final Regulations § ___.20(b).
[18] Final Regulations § ___.4(b)(2)(iii).

exemptions must document use of the exemptions or retain records stating that a fund is not a covered fund. [19] In addition, if a banking entity operates a seeding vehicle that will ultimately register, the compliance program must include a written plan documenting the banking entity's determination that the seeding vehicle will become a registered investment company or SEC-regulated business development company, the period of time in which the vehicle will operate as a seeding vehicle, and a plan to market the vehicle to third-party investors within the time period. [20] Furthermore, if U.S. banking entities invest more than $50 million in foreign public funds, the compliance program must document the value of the ownership interest in each public fund and each jurisdiction in which the foreign public fund is organized. [21]

Appendix B Enhanced Compliance Requirements

An enhanced compliance program should take into account the type, size, scope and complexity of their activities. At a minimum, however, the program must:

- Document, describe and monitor covered activities or investments and the risks of the banking entity related to such activities or investments, identifies potential areas of noncompliance and prevents activities or investments prohibited by, or that do not comply with, the Final Regulations;
- Establish and enforce appropriate limits on covered activities of the banking entity, including size, scope, complexity and risks of the individual activity or investment;
- Subject the effectiveness of the compliance program to independent review and testing;
- Require senior management to be accountable for the effective implementation of the compliance program and ensure that the CEO or the board of directors review the effectiveness of the program; and
- Facilitate the supervision of the banking entity's covered trading activities and covered fund activities or investments by the regulators.[22]

The Appendix B enhanced compliance requirements set forth more specific minimum standards for proprietary trading activities and covered fund activities. These requirements may be

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[19] Final Regulations § ___.20(e)(1).
[20] Final Regulations § ___.20(e)(3).
[21] Final Regulations § ___.20(e)(4).
[22] Final Regulations app. B.

established at the enterprise level or at a business-unit level. Banking entities engaged in proprietary trading must:

- Have written policies and procedures governing each trading desk that detail processes, mission and strategy, risks, limits, types of clients, customers and counterparties and its compensation arrangements;
- Include a comprehensive description of the risk management program for the trading activity of the banking entity, as well as a description of the governance, approval, reporting, escalation, review and other processes to ensure compliance with the Final Regulations;
- Implement and enforce trading limits for each trading desk;
- For trading desks engaging in risk-mitigating hedging activities, establish, maintain and enforce policies and procedures regarding the use of such instruments, techniques and strategies that each trading desk may use, the manner in which the banking entity will determine that the risks generated by each trading desk have been hedged, the level of the organization at which hedging activity and management will occur, the personnel responsible for such monitoring hedging strategies, the risk management processes to control unhedged or residual risks, and the process for developing, documenting, testing, approving and reviewing all hedging positions, techniques and strategies permitted for each trading desk;
- Identify and ensure that proprietary trading conducted in reliance on an exemption satisfies the exemption; and
- Develop additional quantitative measurements specifically tailored to the particular risks, practices, and strategies of its trading desks. These measurements need not be submitted to regulators but are subject to recordkeeping requirements and must be promptly produced to the relevant agency upon request.

Furthermore, banking entities engaged in covered fund activities must:

- Establish a process for identifying all covered funds that the banking entity sponsors, organizes or offers, and covered funds in which the banking entity invests;
- Identify all funds and pools in which the banking entity invests, the amount of ownership interest, and the type of exemption from the Investment Company Act or Commodity Exchange Act on which the banking entity relies;
- Document and map where in the banking entity any covered fund activities may be conducted;
- Include an explanation of compliance;

- Describe sponsorship activities related to covered funds;
- Establish, maintain and enforce internal controls reasonably designed to ensure that covered fund activities or investments comply with the requirements of the Rule;
- Monitoring of the banking entity's investments in and transactions with any covered funds; and
- Document a plan for seeking unaffiliated investors and ensure that transactions with a covered fund comply with the Final Regulations.

Responsibility and accountability

- The CEO must attest that processes exist to establish, maintain, enforce, review, test, and modify the compliance program.
- The board of directors and the CEO must set an appropriate culture of compliance and establish policies regarding the management of covered trading activities and covered fund activities and investments.
- The board of directors and the CEO must approve and ensure the effective implementation and enforcement of the compliance program.

Independent testing

- Banking entities must ensure that the compliance program, policies and procedures, management procedures and actual compliance with each are independently tested annually by a qualified independent party, which could be a banking entity's internal audit department, outside auditors, consultants or other qualified independent parties.

Training

- The banking entity must provide training to its trading personnel and managers to effectively implement and enforce the compliance program, with frequency appropriate to the size and risk profile of the banking entity's covered activities.

Recordkeeping

- The banking entity must maintain adequate records to demonstrate compliance and support the operation and effectiveness of the program. The records would have to be maintained for a minimum of five years.

Reporting and Recordkeeping Requirements

The Final Regulations require banking entities to furnish to regulators certain quantitative measurements of proprietary trading activities and to create and maintain records documenting the preparation and content of these reports. [23] The reporting requirements apply only if a banking entity has, together with its affiliates and subsidiaries, trading assets and liabilities above $10 billion, excluding U.S. government or agency trading assets and liabilities. [24] Foreign banking entities need only count trading assets of U.S. operations. [25]

The following table lists the seven quantitative measurements that must be reported. The Final Regulations reduced the number of metrics that banking entities must report from seventeen in the proposed rule to seven. The metrics must be reported at the trading desk level and measured daily. [26]

[23] Final Regulations § ___.20(d).
[24] Final Regulations § ___.20(d).
[25] Final Regulations § ___.20(2)(1)(ii).
[26] Final Regulations app. A.

Scope of Required Reporting

	Measurement	Calculation Period
Risk-Management Measurements	Risk and Position Limits and Usage • The amount of risk that a trading desk is permitted to take and the portion of the trading desk's limits that is accounted for by the current activity of the desk.	One trading day
	Risk Factor Sensitivities • Changes in a trading desk's profit and loss that are expected to occur in the event of a change in one or more underlying variables that are significant sources of the trading desk's profitability and risk.	One trading day
	Value-at-Risk and Stress VaR • The risk of future financial loss in the value of a given set of aggregated positions over a specified period time based on current market conditions or during significant financial stress.	One trading day
Source-of-Revenue Measurements	Comprehensive Profit and Loss Attribution • Daily profit and loss of the aggregated positions attributable to existing positions, new positions, and residual profit and loss that cannot be attributed to existing or new positions.	One trading day
Customer-Facing Activity Measurements	Inventory Turnover • Compares the absolute value of all transactions over the reporting period to the value of the trading desk's inventory at the beginning of the reporting period.	30 days, 60 days, and 90 days
	Inventory Aging • The amount of time a trading desk has held assets and liabilities.	One trading day
	Customer-Facing Trade Ratio • Compares the transactions involving customers versus non-customers as counterparties.	30 days, 60 days, and 90 days

The effective compliance dates for reporting as follows:

Size of Bank Entity	Effective Date	Frequency of Reporting
$10 billion to $25 billion	December 31, 2016	Quarterly
$25 billion to $50 billion	April 30, 2016	Quarterly
$50 billion +	June 30, 2014	Monthly

Recordkeeping

A banking entity subject to the reporting requirements must create and retain records documenting the preparation and content of any quantitative measurement, as well as such information as is necessary to permit the relevant regulator to verify the accuracy of such measurements, for a period of five years.

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