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The Volcker Rule—Where to Begin?

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As part of the on-going Dodd-Frank Act rules and regulation implementation, section 619, more commonly known as the Volcker Rule (Rule) was finalized in December 2013 with a few tweaks during the first quarter of 2014.[i] The main undertow of the Rule is to prohibit, "[a] banking entity and nonbank financial company supervised by the Board (Board of Governors of the Federal Reserve System, hereinafter FRB) to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund.[ii]

After testing the rule making partnership between financial regulatory agencies as seen with the Securities Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) Joint Final Rule for Identity Theft,[iii] three additional agencies joined the rule making collaboration for the Volcker Rule. Together the SEC, CFTC, FRB, Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC) outlined the compliance requirements banking entities engaged in "significant" trading operations are required to establish, conform to and implement.[iv] The final compliance rule becomes effective on April 1, 2014. However, the comprehensive conformance period extends to July 21, 2015.

A quick Internet search provides hundreds of articles outlining the Rule from one-page overviews, to 35–150+ pages of analysis regarding the 1089 page federal register publication of section 619. Yet, at the end of the day what a compliance officer wants to know is, "Does the Volcker Rule apply to my institution and, what is the role of the Compliance Department for implementing the Rule?"

From a Compliance Department standpoint, where do you begin? Do not let the Rule paralyze you! At the very least you can register for webinars or enlist a competent compliance agency, or legal team, to assist with the process. It can be overwhelming and granted a one-size shelf product of written policy, procedures and controls (PPCs) does not fit all. Appendix B of the Rule requires a banking entity to establish, maintain and enforce an enhanced minimum standards compliance program. In addition an enhanced compliance program for proprietary trading shall include written policies and procedures appropriate for the types, size, and complexity of, and risks associated with its [banking entity] permitted trading activities.[v]

The following commentary is provided as an initial guide for those charged with the task of implementing the appropriate compliance checks and balances. The Volcker Rule uses the subjective terminology, "reasonably designed" when dealing with the six components for the compliance program. The half dozen requirements include: written policies and procedures incorporating the process to follow the Rule; establishing internal controls; implementing a management structure which clearly demonstrates a responsibility and accountability chain; independent testing and auditing of the PPCs; training; and of course, record keeping.

The questions and subsequent information are provided as a high level, first round compliance evaluation. Prior to assessing the sections for a reasonably designed compliance program, the Compliance Department should break down the basics of the Rule in light of a financial institution's business model concerning proprietary trading and the applicable ownership interests. The analysis will assist in formulating the foundation for the six compliance components outlined by the Rule.

Question One: Is the financial institution deemed a banking entity?

The Banking Entity

As with most rules and regulations the Rule has a plethora of exemptions. However, the first step is to determine if the financial institution falls under the definition of a banking entity. A banking entity[vi] is defined as:

- Any insured depository institution;
- Any company that controls an insured depository institution such as a bank holding company;
- Any company that is deemed a Foreign Banking Organization (FBO) holding U.S. bank subsidiaries and
- Any affiliate or subsidiary of any entity controlled by the bank holding company.

For the Volcker Rule a banking entity does not include:

- A covered fund that is not itself a banking entity; or
- A portfolio company held under a small business investment company[vii]

As the Compliance Department you may deem this an obvious question. However, you may not be aware of all the business lines or affiliated relationships under the holding company, which may define the institution as a banking entity. One option is to create a questionnaire concerning the relevant definitions and business activity overseen by the Rule and the applicable agencies. Submit the questionnaire to the appropriate business departments for completion in a timely manner. Give the Compliance Department additional time to track down the completed questionnaires. The questionnaires will allow the Compliance Department to channel its efforts in the appropriate direction. You do not want to be blind-sided by an unknown book of business, which pulls the entity under the Rule or creates a hiccup after the first round of policy and procedure implementation.

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Question Two: Does the financial institution have less than $10 billion in total assets?

The Rule places a minimal burden on banks holding less than $10 billion in total assets (Community Banks).[viii] However, the Compliance Department should affirm what the consolidated assets are related to and where they are "held" within the financial institution(s). Assets tipping the scales over the dollar threshold may need further review. Consider a meeting with the finance and accounting departments. Request a flow chart of investments and entities responsible for the oversight of the respective funds. Who oversees the entity's(ies') annual filings? A meeting with the secretary for each board may also provide the necessary information needed to create a comprehensive flow chart. Either way, the Compliance Department should expressly state in each entity's written PPCs whether the bank is above or below the threshold along with supporting documentation. Keep in mind; proprietary trading may draw a Community Bank back into the full Rule requirements, prior to addressing the next round of exemptions.

The Compliance Department can now begin to compile the requested internal information. The information will assist in formulating a better understanding of the financial institution as well as the lines of business within and outside the entity. Concluding the entity is defined as a bank and affirming the status of the $10 billion threshold will lead to the next question.

Question Three: Does the banking entity engage in proprietary trading?

The Volcker Rule prohibits the banking entity from engaging in short-term proprietary trading of securities, derivatives, commodity futures and options for the entity's own account, subject to certain exceptions. The Compliance Department must have a comprehensive understanding of the financial instruments and the "types" of trading accounts the banking entity holds. The Rule defines a trading account as any account used by the banking entity to:

- Purchase or sell one or more financial instruments principally for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging one or more positions resulting from any of the foregoing purchases or sales[ix]

- Purchase or sell one or more financial instruments that are both covered positions and trading positions (or hedges of other covered positions) under the market risk capital rule[x] applicable to certain larger banking entities; or

- Purchase or sell one or more financial instruments for any purpose if the banking entity is required to be licensed or registered to engage in the business of a dealer, swap dealer or security-based swap dealer, or is engaged in such business outside of the United States, to the extent the instrument is purchased or sold in connection with such activities.[xi]

The Compliance Department is encouraged to follow the trail of accounts and gain a comprehensive understanding of how the process for each instrument is conducted. Of course this is done under the light of the Rule exceptions as well. Ask, "Can the Compliance Department adequately define the prohibited financial instruments? Can the Compliance Department follow the transaction trail to know if the prohibited activity is being conducted? How do the Information Technology, Programming and Systems Security departments play in to checks and balances? If internal departments affirm they can monitor the process, what is the long-term goal, timeframe and cost? What will be disrupted if a checks and balances software is implemented?"

Create an additional flow chart noting the trading activity the banking entity engages in and if it is now deemed prohibited activity or exempted under the Rule. Acknowledge the activity in the forthcoming PPCs along with the liquidation plan and timelines for resolution, if warranted. If the activity is exempted state why the activity is exempted citing the applicable Rule section(s). Engage the trading desks and applicable finance departments in assisting with verbiage and process creation and accountability. Open communication is key.

Question Four: Does the banking entity engage in acquiring or retaining an ownership interest in, sponsoring or having certain relationships with hedge funds or private equity funds, also known as covered funds?

The covered funds provision sets limits on the amount of investments banking entities may make in covered funds as well as the types of relationships banking entities may have with covered funds. Provisions are designed to limit exposure, ensure banking entities do not attempt to bail out other investors in covered funds and prevent banking entities from using covered funds to evade the prohibition on proprietary trading.[xii]

As previously expressed the Compliance Department's comprehension of financial instruments and avenues to utilize the instruments through hedge funds and private equity funds is key. With the recent implementation of regulatory requirements by the SEC and CFTC regarding investment advisor requirements for hedge funds, the Compliance Department may already have a grasp of the activity being conducted by the banking entity. If not, start with the same process recommended for the proprietary trading accounts.

Keep in mind the following definitions when evaluating the institution's activity:

- Ownership interest-any equity, partnership or other similar interest.
- Sponsoring
    - Serving as a general partner, managing member or trustee of a covered fund or serving as a commodity pool operator with respect to a covered fund;

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- Selecting or controlling in any manner (including staff members, officers, directors or agents who constitute) a majority of the directors, trustees or management of a covered fund; or
- Sharing with a covered fund the same name or variation of the same name for corporate, marketing, promotional or other purposes

For the Volcker Rule, a covered fund is:

- An issuer that would be an "investment company" as defined in the Investment Company Act of 1940, but for Section 3(c)(1) or 3(c)(7) of that Act (e.g., most private equity, venture capital and hedge funds);
- Certain "commodity pools" under Section 1a(10) of the Commodity Exchange Act; or
- For U.S. banking entities, certain foreign funds that are similar to U.S. covered funds.

The Rule allows fourteen entity exclusions when determining if the activity is deemed prohibited. As always go through the process, "Is the activity a covered fund? If yes, does it fall under the exclusions, why or why not?" Regardless of the determination, the final analysis should be documented, documented, documented in the PPCs.

Question Five: Which regulatory agencies have jurisdiction over the applicable activity?

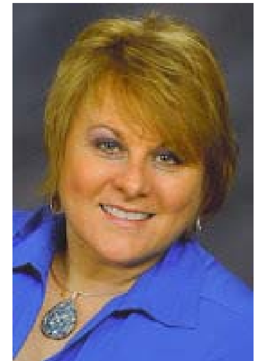
Five regulatory agencies have come together to enforce the Rule. From a Compliance Department standpoint the question looms, "How can one entity satisfy the five regimes?" Three agencies are focused on the banking side; two are focused on the markets. Entities and Compliance Departments may find themselves looming between a good cop/bad cop scenario. While in the past, the banking regulators have demonstrated a preference for resolving matters prior to notifying the public sector regarding the final violation outcome; the market regulators, under their respective rules, publish the warnings concerning pending enforcement, then resolve.

What will resolution look like between the five agencies?

In his speech to the Committee on Financial Service, Daniel K. Tarruno stated, "[t]he Federal Reserve and other agencies take a comprehensive and appropriately tough approach to monitoring and constraining the risks in all trading operations of our largest financial institutions."[xiii] Therefore it appears authority to order banks, broker dealers and commodity pool operators to stop trading activity or divest certain holdings is available to all five regulators under the Rule. In addition, the five agencies created an inter-agency working group charged with reviewing the Rule to ensure enforcement agreement between the agencies. This approach causes industry consultants to express concerns over the Rule and possibly creating multiple regulators targeting the same activity in a single firm. Compliance Departments may find themselves also dealing with the applicable self-regulatory agencies (SROs) as well.

It seems a bit ironic how the six compliance program components outlined by the Rule: creating written policies and procedures incorporating the process to follow the Rule; establishing internal controls; implementing a management structure which clearly demonstrates a responsibility and accountability chain; independent testing and auditing of the PPCs; plus training; and record keeping, appear to be the same six components the regulators and the inter-agency working group are addressing to implement the oversight and enforcement process. At the end of the day, both the private and public sectors must establish open communication among the applicable parties and document, document, document.

About the author



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Kim has over 13 years of experience in the financial markets. Kim's areas of expertise include SEC and FINRA regulatory compliance in the following areas: SEC Investment Company Act of 1940 (IC Act), Investment Advisers Act of 1940 (IA Act), Securities Exchange act of 1934, and Securities Act of 1933, as well as FINRA's regulations governing broker/dealers. Kim's extensive 1940 IC Act expertise is focused primarily on hedge and mutual funds and variable insurance products. Kim also specializes in Dodd-Frank implementation, anti-money laundering, anti-fraud, commodities futures, and foreign exchange.

Based on her educational background and in-depth knowledge, Kim is a highly sought after conference speaker, domestic and internationally. She is a published author and litigations consultant and holds membership in numerous professional organizations.

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[i] Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat.1376 (July 21, 2010) ("Dodd-Frank" or the "Act"); Section 13 of the Bank Holding Company Act ("BHC Act"), 12 U.S.C. § 1851

[ii] The Final Rule may be found at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a1.pdf. The Final Rule was accompanied by a long explanatory commentary ("Attachment B"). Attachment B may be found at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a2.pdf.

[iii] 2 C.F.R. § __.90 and 16 C.F.R. § 681.2. (Section citations reference the uniformly numbered rules issued by the Federal Financial Institution Regulatory Agencies and the rules issued by the FTC.)

[iv] See www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm

[v] 2 C.F.R. § __.20(c)

[vi] 12 U.S.C.§ 1843(k)(4)(H).

[vii] 12 U.S.C. § 1843(k)(4)(I).

[viii] Total consolidated assets of $10 billion or less as reported on December 31 of the previous two calendar years.

[ix] The purchase or sale of a financial instrument by a banking entity that is held for less than 60 days is presumed to be for the banking entity's trading account unless the banking entity can demonstrate that the position was not purchased or sold for any of these purposes.

[x] Defined as calculating risk-based capital ratios under the market risk capital rule, a trading account includes accounts used to buy or sell one or more financial instruments that are both market risk capital rule covered positions and trading positions (or hedges of other market risk capital rule covered positions).

[xi] See http://www.lexology.com/library/detail.aspx?g=b5d3feb3-0d02-4eeb-abab-ebef2c212ea6

[xii] Tarullo, Daniel K. (statement, U.S House of Representatives; Committee on Financial Services Washington D.C., February 5, 2014)

[xiii] ibid.,6