Bloomberg BNA

BNA's
Banking Report™

Reproduced with permission from BNA's Banking Report, 102 BBR 647, 4/8/14, 04/08/2014. Copyright © 2014 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

BANK SUPERVISION

The Volcker Rule's Trojan Horse for Smaller Banking Entities

BY OLIVER IRELAND AND DANIEL NATHAN

The final rules recently enacted to implement the Volcker Rule ("the Final Rules")[1] impose on the largest banking entities a highly detailed and complex compliance regime. As to those so-called "less active banking entities," that is, the smaller banking entities and those not engaged in any proprietary trading activities at all, the Final Rules appear to provide relief from that compliance regime. Compared to the proposed rules that were issued over two years ago,[2] this "simplified program" seems like a gift from the enacting agencies (the "Agencies"), who appear to be taking a less prescriptive approach to compliance at those smaller banking entities. But upon closer analysis, the "gift" begins to look like a Trojan Horse, that will still require the less active banking entities to have a compliance program that addresses the Volcker Rule's restrictions, even when the entity is engaged in limited or no activities covered by the Rule.

[1] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg.5536 (Jan. 31, 2014).

[2] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (Nov. 7, 2011).

Oliver Ireland is a partner in the Financial Services Group of Morrison & Foerster. Daniel Nathan is a partner in the Securities Litigation, Enforcement and White-Collar Criminal Defense Group of Morrison & Foerster.

I. The Volcker Rule's Compliance Regime

The Volcker Rule generally prohibits a banking entity from engaging in proprietary trading[3] and from acquiring or retaining an ownership interest in or sponsoring a hedge fund or private equity fund.[4] The Volcker Rule expressly permits certain trading and fund activity – notably, underwriting activities, market making-related activities, and risk-mitigating hedging activities.[5] The Final Rules impose compliance and reporting requirements for banking entities "to prevent violation or evasion of the prohibitions and restrictions on proprietary trading activities and covered fund activities and investments."[6]

The Final Rules effectively create three tiers of firms, depending upon their size and the extent of their trading activity, with varying compliance obligations. As a starting point, all firms are required to adopt a six-point compliance program.[7] On top of that, the firms in the top tier also are required to satisfy enhanced minimum standards.[8] The "less active" firms in the bottom tier appear to have a less rigorous set of obligations.

A. The Middle Tier

The compliance program that banking entities in the middle tier are required to adopt is required by the Final Rules to have the following six elements:

- Written policies and procedures reasonably designed to document, describe, monitor and limit proprietary trading activities, and activities and investments with respect to covered fund activities, to ensure that all

[3] § __.3, 79 Fed. Reg. at 5781.

[4] § __.10, 79 Fed. Reg. at 5787.

[5] § __.4, 79 Fed. Reg. at 5783; § __.5, 79 Fed. Reg. at 5784.

[6] 79 Fed. Reg. at 5748.

[7] § __.20(b), 79 Fed. Reg. at 5796.

[8] Appendix B, 79 Fed. Reg. at 5800-04.

activities and investments conducted by the banking entity comply with the Volcker Rule and the Final Rule;

■ A system of internal controls reasonably designed to monitor compliance with the Volcker Rule, and to prevent the occurrence of activities or investments that are prohibited by the Rule;

■ A management framework that delineates responsibility and accountability for compliance with the Volcker Rule and includes appropriate management review of trading limits, strategies, hedging activities, investments and incentive compensation, among other things;

■ Independent testing and audit of the effectiveness of the compliance program. The testing may be conducted by ''qualified'' personnel of either the banking entity or an outside party;

■ Training for trading personnel and managers, as well as other ''appropriate'' personnel, to appropriately implement and enforce the compliance program; and

■ Records sufficient to demonstrate compliance with the Volcker Rule, which records must be provided to the regulator upon request and retained for five years.[9]

B. The Upper Tier

The largest banking entities are in the upper tier, and in addition to the six-point program, they are required to adopt the ''Enhanced Minimum Standards for Compliance Programs'' that are set forth in Appendix B.[10] The upper tier consists of banking entities that:

(1) engage in permitted proprietary trading and are required to comply with the reporting requirements under Appendix A (that is, those entities for which the average gross sum of trading assets and liabilities over the previous four quarters exceeded $50 billion, a level that will gradually decline to $10 billion, as discussed below);

(2) as of the previous calendar year-end, had total consolidated assets of $50 billion or more or, in the case of a foreign banking organization, had total U.S. assets of $50 billion or more; or

(3) are notified by the relevant Agency that they must satisfy the standards of Appendix B.[11]

C. The Lower Tier

The Final Rules impose ''simplified'' compliance programs on ''less active'' banking entities, as follows:

■ banking entities with no covered activities have no obligation to establish a ''compliance'' program until they begin to engage in such activities;

■ banking entities with ''modest activities,'' that is, those with total consolidated assets of less than $10 billion, need only refer to the requirements of the Volcker Rule in its compliance policies and procedures and make ''adjustments as appropriate given the activities, size, scope and complexity of the banking entity.''[12]

II. The Reporting and Recordkeeping Regime

The Final Rules also require the larger firms in terms of trading assets and liabilities that are engaged in permitted proprietary trading to furnish the regulators with periodic reports providing various quantitative measures, and to maintain records regarding the preparation and content of those reports.[13] Specifically, this recordkeeping and reporting regime is required of banking entities engaged in permitted proprietary trading whose average gross sum of trading assets and liabilities over the previous consecutive four quarters, as measured on the last day of each quarter, exceeded $50 billion between June 30, 2014 and April 29, 2016, $25 billion between April 30, 3016 and Dec. 30, 2016, and $10 billion beginning on Dec. 31, 2016.[14] The principal purpose of the reporting and recordkeeping requirements is to assist banking entities and the regulators in determining whether the banking entities are complying with the Rule.

The seven metrics required by the Rule must be measured daily,[15] and for most banking entities must be reported for each calendar month within 30 days of the end of the month.[16] However, for banking entities with significant trading ($50 billion or more in trading assets and liabilities), beginning with information for the month of January 2015, the information must be reported within 10 days of the end of the month.[17] Banking entities must create and maintain records documenting the preparation and content of these reports for five years from the end of the calendar year for which the measurement was taken.[18]

III. The ''Trojan Horse''

A. ''Simplified Compliance Programs'' for Less Active Banking Entities

As discussed above, § __.20(f) of the Final Rules allows the ''less active'' banking entities to adopt a simplified compliance program. But to what extent does the availability of simplified compliance programs ease the burden of those less active banking entities under the Volcker Rule? On its face, this provision appears to tell banking entities that do not engage in any proprietary trading, permitted or otherwise, that they need not establish a Volcker Rule-specific compliance program unless and until they begin to engage in proprietary trading.[19] This represents a material change from the Proposed Rule, which had provided that even if a banking entity did not engage in any covered activities (permitted proprietary trading and investing in a hedge fund), it still had to include in its policies and procedures measures that were designed to prevent the banking entity from becoming engaged in such activities.[20] In the Preamble, the Agencies indicate that they listened to the concerns expressed about the possible burdensome impact on community banks, who would be

[9] § __.20(b), 79 Fed. Reg. at 5796.
[10] Appendix B, 79 Fed. Reg. at 5800-04.
[11] § __.20(c), 79 Fed. Reg. at 5796.
[12] § __.20(f), 79 Fed. Reg. at 5797; as explained at 5545.

[13] Appendix A, 79 Fed. Reg. at 5797-98.
[14] § __.20(d)(2), 79 Fed. Reg. at 5797.
[15] Appendix A, IV. Quantitative Measurements, 79 Fed. Reg. at 5798-5800.
[16] § __.20(d)(3), 79 Fed. Reg. at 5797.
[17] *Id.*
[18] Appendix A, III. Reporting and Recordkeeping of Quantitative Measurements, 79 Fed. Reg. at 5798.
[19] § __.20(f)(1), 79 Fed. Reg. at 5797.
[20] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846, 68,938 (Nov. 7, 2011).

 COPYRIGHT © 2014 BY THE BUREAU OF NATIONAL AFFAIRS, INC. BBR ISSN 0891-0634

forced to hire specialists to amend their policies and procedures even though they were engaged in no covered activities.[21] Consequently, the Final Rules do not require a banking entity that engages in no covered activities to develop and provide a compliance program until it engages in covered activities.

The provision also appears to tell the ‘‘less active’’ banking entities that engage in permitted activities but that are below a certain size that it is enough to include in its existing compliance regime ‘‘appropriate references’’ to the requirements of the Volcker Rule and the Final Rules.[22]

However, further analysis of these provisions regarding simplified compliance programs demonstrates that the ‘‘less active’’ banking entities are far from getting a pass on implementing a Volcker Rule compliance program.

1. Banking Entities with No Covered Activities

The Preamble states that the Final Rules improve on the Proposed Rule with respect to the compliance obligations of a banking entity with no covered activities.[23] However, this modification leaves unanswered these related questions:

- how will a banking entity ensure that it is not engaged in any activities prohibited by the Volcker Rule, and demonstrate it to the regulators?; and
- how will a banking entity comply with the prudential backstops for permitted proprietary trading and fund investments?

The answer to the first question is important: unless a banking entity can ensure that it is not engaged in any covered activities, it takes a substantial regulatory risk if it decides not to implement a comprehensive compliance regime. Similarly, if the banking entity cannot satisfy a supervisor that it is not engaged in any covered activities, then it risks a finding by the supervisor that it violated the Volcker Rule. Given the central role of a firm's compliance program in the implementation of the Volcker Rule, a supervisor is likely to be vigilant in examining a banking entity for Volker Rule compliance, and is unlikely to give a banking entity a pass in that regard without tangible proof. In order to ensure that the entity is not engaged in any covered activities, a banking entity will need to examine its trading across the organization and determine whether any of its trading is proprietary. Such an analysis might require a review of every desk where securities or other financial instruments are purchased or sold. If the analysis confirms that the entity is not engaged in any covered activities, then that determination will need to be documented, and the review and analysis will still need to be repeated at regular intervals to ensure that no covered activities have commenced. On the other hand, if the analysis determines that the banking entity is in fact engaged in proprietary trading, the entity will need to implement a compliance program that reviews the trading for compliance with the Volcker Rule, and documents that determination and all resultant decisions.

2. Banking Entities with ‘‘Modest Activities’’

A banking entity with total assets of $10 billion or less – described by the Final Rules as ‘‘modest activities’’ – need only refer to the requirements of the Volcker Rule in its compliance policies and procedures and make ‘‘adjustments as appropriate given the activities, size, scope and complexity of the [banking entity].’’[24] The Preamble recites the advantage of this approach: it allows the banking entities with total assets below $10 billion ‘‘to fold compliance measures into their existing compliance program in a manner that addresses the types and amounts of activities the entity conducts.’’[25]

This approach appears to reduce the compliance program obligations on those lower tier banking entities, and gives those entities discretion to base the extent of the compliance program upon the ‘‘activities, size, scope and complexity’’ of the entity.[26] However, what the Final Rules give with one hand, they take away with the other. The Final Rules do not let the ‘‘modest activity’’ banking entities out of the strictures of the six-point compliance program; rather, in requiring that such entities include in their existing programs ‘‘appropriate references’’ to the Volcker rule, the Final Rule is in effect allowing those firms to integrate the six-point program into their existing policies and procedures and to make adjustments as appropriate based on the activities, size, scope and complexity of the banking entity.

However, further analysis of these provisions regarding simplified compliance programs demonstrates that the ‘‘less active’’ banking entities are far from getting a pass on implementing a Volcker Rule compliance program.

Moreover, any banking entity engaged in permitted proprietary trading is also required to implement a compliance program with additional specific requirements, and these would apply to banking entities in any of the three tiers. For example, § __.4(b) permits banking entities to engage in market making-related activities provided, among other things, ‘‘the banking entity has established and implements, maintains, and enforces an internal compliance program required by subpart D . . . that is reasonably designed to ensure the banking entity's compliance with the requirements of paragraph (b).’’[27] The section lists five areas specific to market-making that the written policies and procedures, internal controls, analysis and independent testing are required to address, including the financial instruments that each trading desk needs to stand ready to purchase and sell, and the limits for each trading desk.[28]

Similarly, the underwriting exemption in § __.4(a) requires that a banking entity establish and implement, maintain, and enforce an internal compliance program

[21] 79 Fed. Reg. at 5752-53.
[22] § __.20(f)(2), 79 Fed. Reg. at 5797.
[23] 79 Fed. Reg. at 5752-53.
[24] § __.20(f)(2), 79 Fed. Reg. at 5797. *See also* 79 Fed. Reg. at 5545, 5778.
[25] 79 Fed. Reg. at 5750.
[26] § __.20(f)(2), 79 Fed. Reg. at 5797. *See also* 79 Fed. Reg. at 5545, 5778.
[27] 79 Fed. Reg. at 5783.
[28] *Id.*

required by subpart D that is reasonably designed to ensure compliance with the conditions for permitted underwriting, and lists four areas specific to underwriting that the written policies and procedures, internal controls, analysis and independent testing are required to address.[29] Finally, § __.5(b) conditions permission for a banking entity to engage in risk-mitigating hedging activities on, among other things, having an internal compliance program that is reasonably designed to ensure compliance with the requirements of the hedging exemption.[30]

Thus, with respect to smaller banking entities engaged in permitted covered activities, the Final Rules both require a six-point compliance program and apply specific and prescriptive requirements to smaller institutions engaged in permitted covered activities. It is a fair question whether, as a practical matter, the Agencies are doing those smaller firms any favors by allowing the purported ''simplified'' program permitted under § __.20(f). While the larger banking entities are designing stand-alone programs for Volcker Rule compliance that will exist in addition to the firms' existing compliance program, the smaller firms engaged in permitted activities are ''permitted'' to comb through their existing procedures, and determine where to build in the policies and procedures, controls, analysis and testing that will ensure that those activities are conducted in compliance with the Rule. Engaging in that process may turn out to require as much effort as if the entity had created a new Volcker Rule compliance program from scratch. On the other hand, the advantage to incorporating a compliance program into the existing policies and procedures is in the consistency that it provides to a banking entity and the ability to take advantage of the experience, training, and existing governance structure to carry it out. Time will tell whether the less active firms were helped by this rule.

B. Prudential Backstops

The Final Rules also include a ''backstop'' provision that prohibits otherwise permitted proprietary trading activities if (i) they would involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties; (ii) they would result in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or (iii) they pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.[31] Thus, while Volcker Rule provides for an exception from the ban on proprietary trading for, for example, government securities and for market making and underwriting in all types of securities, the prudential backstops provide for an exception from that exception; failure to comply with these prudential backstops can disqualify a banking entity from engaging in otherwise permitted proprietary trading.

The prudential backstop provision in § __.7 does not explicitly require a compliance program. However, a banking entity – including ''limited activity'' banking entities that are subject to the simplified compliance programs under § __.20(f) – that decides to engage in permitted proprietary trading would certainly need to adopt a compliance program that ensures compliance with the prudential backstops. Otherwise, infringement of one of the backstops through a single event involving, for example, a conflict of interest or high risk activity, would disqualify the entity from engaging in otherwise permitted proprietary trading activity. That disqualification could negate the extensive effort and expense that the banking entity had put into thoroughly redesigning or enhancing its compliance program in order to accommodate that permitted activity.

The risks to a firm engaging in exempted activities are only increased by the fact that the conditions that would cause an otherwise permitted activity to be impermissible are defined somewhat subjectively. For example, the Preamble states that not all conflicts of interest are ''material,'' but does not explain that distinction aside from stating that ''certain inherent conflicts, such as the mere fact that the buyer and seller are on opposite sides of a transaction and have differing economic interests, would not be deemed a 'material' conflict of interest with respect to permitted activities.''[32] Similarly, ''high-risk asset'' and ''high-risk trading strategy'' are not defined in the Final Rule or the Preamble beyond the shared definition that they mean an asset or group of assets that would, if held by a banking entity, or a strategy that would, if engaged in by a banking entity, ''significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.''[33]

It is a fair question whether, as a practical matter, the Agencies are doing those smaller firms any favors by allowing the purported "simplified" program permitted under § __.20(f).

The Final Rules do outline the additional procedures that a banking entity must adopt in order to mitigate a material conflict of interest that would otherwise disqualify the entity from a permitted activity.[34] In order to engage in the permitted activity in the face of a material conflict of interest, a banking entity must, prior to effecting the specific transaction, or engaging in the specific activity, either make timely disclosure of the conflict of interest, in a manner that provides the client, customer or counterparty the opportunity to negate or substantially mitigate any material adverse effect on the client, customer or counterparty, or establish, maintain and enforce information barriers that are memorialized in written policies and procedures.[35] The Preamble provides some elaboration about effective disclosure, such as that disclosure should be provided to allow a sufficient period of time for the client, customer or counterparty to evaluate and act on the information, but should not be provided too far in advance of the actual conflict.[36] The Final Rules provide broad examples of infor-

[29] *Id.*
[30] 79 Fed. Reg. at 5784-85.
[31] § ___.7, 79 Fed. Reg. at 5786.

[32] 79 Fed. Reg. at 5664.
[33] 79 Fed. Reg. at 5665.
[34] § ___.7(b)(2), 79 Fed. Reg. at 5787.
[35] *Id.*
[36] 79 Fed. Reg. at 5659.

 COPYRIGHT © 2014 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0891-0634

mation barriers, including physical separation of personnel or functions, or limitations on types of activity.[37]

Of course, if a banking entity has no material conflicts of interest, it need not be concerned with adopting policies or procedures that mitigate such conflicts of interest; moreover, if it is not materially exposed to a high-risk asset or high-risk trading strategy, then it need not be concerned in that regard. These possibilities presuppose that the entity has the ability to identify material conflicts or high-risk assets or trading strategies. In view of the broad and subjective definitions provided by the Final Rule, the entity must take care to adopt procedures designed to allay that concern.

IV. Conclusion

As is apparent, there is little escape for a banking entity, regardless of size or level of activity, from some level of new compliance obligations under the Volcker Rule. Where the Rule applies, compliance programs must be designed to meet the specific strictures of the Rule, and where the Rule does not apply, compliance programs must be designed to establish and demonstrate that conclusion. While community banks and other smaller institutions might appear to have obtained some of the relief from the Volcker Rule's extensive obligations that they so eagerly sought in the comment process, that relief is far from complete on its face, and further analysis demonstrates that additional compliance enhancements are necessitated by the Rule. The one-year extension granted by the Agencies for compliance with the Rule will come in handy for banking entities, as they work through these requirements.

[37] § ___.7(b)(2)(ii), 79 Fed. Reg. at 5787.