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Regulatory brief

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Volcker Shrugged

Overview

The most eagerly awaited final rule in the history of financial regulation was delivered last week – 1,238 days since it became law and 764 days since being formally issued in proposed form.[1]

Was the final Volcker rule worth the wait?

For foreign banks and custody banks, the answer is clearly yes. The expansion of the SOTUS exemption and the narrowing of the covered fund definition from the original version of the rule gave those banks most of what they wanted. For most of the US regional banks, it is largely a non-event. For universal and major investment banks, however, the answer will ultimately depend on how the rule will be interpreted, supervised, and enforced by regulators. Will the regulators use the discretion the new rule grants them in a pragmatic way or in a punitive fashion? It is really too early to know.

What is known though is that you no longer need "a lawyer and a psychiatrist" to comply with the rule's trading provisions. Rather than prescribing what is or what is not a prop trade, the rule puts the onus on banks to prove that they are not prop trading and gives the regulators wide latitude to decide if the banks are meeting their burden of proof. The original rule draft had prescribed definitional lines – which is what the banks asked for at the time – but the lines drawn by the regulators were in all the wrong places. If applied, the original draft would have seriously impacted bank profitability and curtailed market liquidity (a concern we heard often from both the buy- and sell-side, and that is not necessarily alleviated in the final rule).

So, the final rule's grant of supervisory discretion is welcome relief at this point, but the key is how the regulators will use their discretion. Banks with over $50 billion in trading assets and liabilities will have to start "proving their case" by reporting metrics on June 30, 2014. The following year, CEOs will have to start certifying that they have control processes in place to effectively comply with the rule. The name of the game is to "demonstrate" that the bank is not prop trading: the final rule and its preamble use the word in some form 145 times.

On covered funds, the rule takes a different approach. The rule tightens the definition of covered funds to better target hedge funds and private equity funds, in order to avoid capturing other types of vehicles. Most notably, the new definition excludes foreign public funds and certain loan securitization vehicles; this change creates parity between US and global funds (a big foreign win) and provides *some* relief for collateralized loan obligations. The rule did not, as had been hoped, alleviate the Super 23A restrictions.

In short, complying with the final rule seems manageable – but only if the regulators use their discretion wisely. Banks will need strong, well-documented processes to prove their case.

This **Financial Services Regulatory Brief** builds on our brief issued on December 11th.[2] We discuss (a) key changes from the proposed version of the rule, (b) the regulation's implementation and business impact, and (c) our view of what banks should now be doing.

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Key changes

The following is a summary of some of the key changes in the final rule (see the **Appendix** for a comparative chart):

- **Market making:** Desk level market making strategies must include documented limits on financial exposure and inventory that are consistent with "demonstrable" near-term customer demand (based on historical liquidity, maturity, and depth of the market).
- **Hedging:** No specific allowance is made for "portfolio hedging," which is not defined, but hedging is permitted against aggregate positions. Banking entities must be able to demonstrate, at the inception of the hedge, that their hedges reduce or significantly mitigate specific, identifiable risks of the bank (not general expectations of losses), and that the hedges will not give rise to any significant new additional risk that is not itself contemporaneously hedged. Also, banks must engage in "ongoing recalibration" to make sure the hedge is effective.
- **Metrics:** The number of metrics needed to demonstrate Volcker conformance has been reduced from 17 to seven, but banks may need to provide regulators with additional firm-developed metrics to demonstrate that their particular strategies comply with the rule (further evidencing the theme that the onus is on the banks to prove compliance). Metrics reporting begins on June 30, 2014 for banks with trading assets and liabilities of $50 billion or more.
- **SOTUS:** Foreign banks won a more risk-based than transaction-based exemption from the rule's extraterritorial reach in both trading and covered fund activities, i.e., expansion of the *solely outside the United States* exemption ("SOTUS"). Foreign banks meeting certain SOTUS requirements now have more freedom to invest or sponsor foreign covered funds and to conduct their non-US trading activities and will still have conditional access to US clients and counterparties through US exchanges and intermediaries. US banks were not provided with a similar relaxation of the rule on their activities outside of the US – Volcker will apply fully to those activities. The competitive equality arguments of US banks fell on deaf ears with regard to SOTUS.
- **Sovereign debt:** US branches and agencies of foreign banks are allowed to trade in the sovereign debt of their home country. Similarly, a foreign bank or foreign broker dealer owned by a US banking entity is permitted to trade in the sovereign debt of its foreign chartering authority.
- **Covered funds:** The definition of covered funds no longer captures, as examples, foreign retail funds (e.g., European UCITS funds), certain loan securitization vehicles, or most commodity pools. This change was meant to limit the overbreadth of the definition and to level the playing field between US and global funds – however, to the consternation of some issuers, a loan securitization vehicle's underlying assets must be strictly limited to loans in order for the vehicle to fall outside of the covered fund definition.
- **Super 23A:** A major disappointment is the final rule's failure to apply certain key exemptions of the affiliate transaction restrictions of section 23A to a banking entity's transactions with a covered fund that it sponsors, manages, or advises.
- **CEO certification:** CEOs of banking entities that are subject to enhanced compliance standards must attest annually that their controls and processes are "reasonably designed" to ensure compliance with Volcker. The attestation must be based on a "review by the CEO," which should be supported by an auditable, reproducible process that may leverage the independent testing required under the rule as well as a bank's internal audit function. While the attestation is not a blanket guarantee of compliance, it will nevertheless require evidentiary support.

Most of these changes are sensible and were not big surprises – in fact, we forecasted several of them in two prior regulatory briefs.[3] Few anticipated, however, the relaxation of the SOTUS exemption (after the experience with the extra-territorial reach of Dodd Frank's derivatives rules) and the rule's extensive movement towards a more discretionary approach to regulatory oversight.

[1] On December 10, 2013, the final Volcker rule was approved by the five financial institution regulatory agencies ("Agencies") responsible for its implementation. The rule technically goes into effect on April 1, 2014, but the rule's conformance period has been extended by a year through July 21, 2015.

[2] See PwC's *Volcker first take: You no longer need "a lawyer and a psychiatrist" to comply with the rule – just strong, well-documented processes* (December 2013).

[3] See PwC's *Financial Services Regulatory Brief: Volcker Rule – The day of reckoning is near* (November 2013), in which we asserted that (a) the rule would come out this year, (b) there would be fewer reporting metrics ("as few as seven"), (c) the exemption for US debt would be expanded to include other sovereign debt, and (d) the threshold for having to meet the rule's enhanced compliance requirements would be raised ("from $1 billion to $10 billion"). See also PwC's *Financial Services Regulatory Brief: Volcker Rule – Are banks keeping the [good] faith?* (March 2013), which made similar predictions.

Volcker implementation: Risk-based and multi-faceted

The Volcker rule seeks to reduce risks posed to banks by proprietary trading activities and by investments in (or relationships with) covered funds. The Agencies[4] describe their implementation of the rule as "risk-based" and "multifaceted," relying on articulated characteristics of prohibited and permitted activities (and investments) supported by requirements for infrastructure, procedure, and reporting. The stated objective of this approach is to enable banking entities to comply with the rule, while enabling regulators to monitor compliance – and unintended consequences.

The Agencies generally rejected comments urging other approaches, including bright-line tests, safe harbors, and pure regulatory guidance. While a bright-line or safe harbor would generally provide a high degree of certainty in some areas (e.g., about whether an activity qualifies as permissible), the Agencies believed bright lines could provide less flexibility to recognize the differences in activities across markets and asset classes, and could be subject to gamesmanship. On the other hand, although acknowledging that a purely guidance-based approach would provide greater flexibility, the Agencies concluded it would not provide enough specificity, making it difficult for banking personnel and the Agencies to determine whether an activity complies with the rule (leading to increased risk of evasion).

The Agencies' approach is repeated throughout the rule's preamble. They consider multiple viewpoints, test them against the key characteristics of prohibited or permitted activities and investments, and then seek to "balance" the tensions between the statutory prohibitions and exemptions by considering ways to reduce risk through regulatory requirements.

Under this approach, regulators will use the conformance period (through July 21, 2015) to better understand the impact of the rule on banking entities and the industry, and to determine which types of metrics and controls are most effective to achieving the rule's objectives. Meanwhile, banks will use this period to learn what they are allowed, and not allowed, to do.

Proprietary trading

Exclusions from proprietary trading

Unchanged from the proposal, the final rule excludes from the definition of "trading account" transactions not involving short-term trading. Namely, these transactions include the purchase or sale of a financial instrument (a) under certain repurchase and reverse repurchase agreements, (b) under securities lending arrangements, (c) for *bona fide* liquidity management purposes, and (d) by a clearing agency or derivatives clearing organization ("DCO") in connection with clearing activities.

However, the exclusion for liquidity management has been modified in the final rule to ensure that the exclusion is not used for the purpose of proprietary trading. The rule's preamble notes the exclusion no longer applies to hedging of aggregate risks related to asset-liability mismatches or to hedging of other general market risks. Further, the exclusion no longer applies to any trading activities that expose banking entities to substantial risk from market value fluctuation, that is unrelated to the management of near-term funding needs (regardless of the stated purpose of the activity).

The rule also adds new exclusions related to the purchase and sale of a financial instrument, including transactions (i) by a member of a clearing agency, DCO, or designated financial market utility engaged in excluded clearing activities, (ii) to satisfy existing delivery obligations, (iii) to satisfy an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization, or arbitration proceeding, (iv) solely as broker, agent, or custodian, (v) through a deferred compensation or similar plan, and (vi) to satisfy a debt previously contracted.

Permissible (exempt) activities

Risk-mitigating hedging

Under the final rule, risk-mitigating hedging activity may be conducted, but it must be related to identifiable financial positions of the banking entity. The rule imposes this and other hedging restrictions in order to prevent banking entities from taking large positions that use strategies to profit from economic or market developments.

In particular, any permitted hedging activity, at the inception of the hedge, must be designed to reduce or otherwise significantly mitigate one or more specific, identifiable risks – and this must be demonstrable. In addition, the hedging activity must not give rise to any significant new or additional risk that is not itself hedged contemporaneously under the hedging exemption's terms.

The final rule permits risk-mitigating hedging of both individual *and aggregated* positions, contracts, or other holdings of the banking entity, as long as the hedge is related to identified positions, contracts, and other holdings. This requirement is meant to prevent the hedging exemption from being used to engage in trading activities such as scenario hedging, revenue hedging, or general asset-liability management (in addition to other activities not related to individual or aggregated positions, contracts, or other holdings of the banking entity).

[4] See footnote 1.

Unlike the proposed rule, the final rule emphasizes that hedging must be conducted in compliance with a written program. Among other provisions, the program must include terms for the ongoing analysis and monitoring of the correlation of the hedging activity with the underlying positions. The bank must also document unusual or unique hedging activities.[5]

Market making

The final rule on market making includes a number of "refinements" from the proposed rule designed to ensure that exempt market making activity is genuinely client-facing and limited to the reasonably expected near-term demands of clients, customers, or counterparties. At the same time, the rule makes the market making exemption more pragmatic by loosening the noose around traders' ability to engage in permissible market making.

A key example related to both objectives is that the final rule's market making exemption does not require a trade-by-trade analysis like the proposal did, which was a significant source of concern of commenters. Instead the rule focuses on the overall market making activities of the trading desk, applying requirements to the desk's aggregate risk exposure – including risk and inventory limits. This approach is intended to reduce the negative impacts on a trader's decision-making in the normal course of market making, while promoting a business-as-usual process for the desk's compliance with the near-term customer demand restriction.

Also in response to comments, the rule no longer requires market making to be designed to generate revenues primarily from fees (or similar types of customer revenues). Instead, the rule requires banking entities with significant trading activities to report data regarding patterns of revenue generation by desk, which may warrant review of a desk's activities. Additionally, the final rule permits a bank to engage in market making in different types of asset classes, and indicates that market making activity may vary based on historical liquidity, maturity, and depth of the market for the particular financial instrument.

The market making exemption (and in some cases the statutory exemption for underwriting activities, explained further below) also permits banking entities to engage in primary dealer activities, act as an authorized participant for exchange traded funds, and act as a block positioner (subject to the rule's framework and other applicable law).

Finally, the rule does not mandate a shift to an agency model whereby dealers could act only in a broker or agent capacity, nor does it prescribe standardized regulatory limits on the amount of inventory or principal risk that a market maker may retain (although, as noted above, the rule requires the banking entity to establish and enforce these types of limits internally).

Underwriting

The final rule adopts the proposal's underwriting exemption with few changes. In order to rely on this exemption, a trading desk's underwriting position must be related to securities for which the bank acts as underwriter. The rule also requires a compliance program with limits on inventory, exposures, and the period of time an underwriting position is held. The definitions of "distribution" and "underwriter" are redefined in the rule to better capture the scope of securities offerings and the different roles that a bank may play as intermediary in such offerings.[6]

Foreign impact

Foreign sovereign debt

The final rule includes new exemptions for trading in sovereign debt instruments. Namely, US branches and agencies of foreign banks are allowed to trade in the sovereign debt of their home country. Similarly, a foreign bank or foreign broker dealer owned by a US banking entity is permitted to trade in the sovereign debt of its foreign chartering authority.

Trading by foreign banking entities solely outside the United States

A more significant change for foreign banks is that the SOTUS exemption is now applied under a risk-based approach, rather than the transaction-based approach of the proposal. This change allows foreign banks meeting certain SOTUS requirements to trade on US exchanges and through US clearing facilities.[7] This exemption is not available to US banking entities or their foreign subsidiaries.

[5] Unusual or unique hedging activities include (a) hedging that is conducted by a unit of the banking entity other than the trading desk responsible for the underlying position, contract, or other holding, and (b) hedging done by a trading desk using a technique, strategy, or instrument that is not identified in the written hedging policy governing that trading desk.

[6] Other underwriting requirements are largely identical to the requirements for market making activities, except that more detailed risk management procedures are required for market making activities.

[7] A foreign bank may rely on this exemption only if (a) it acts as principal in the transaction outside of the US, (b) the transaction's decision making entity or personnel is not located in the US, (c) the transaction (including any hedging) is not accounted for as principal in the US, (d) no financing for the transaction is provided by a US affiliate of the foreign bank, and (e) the transaction is not conducted with or through any US entity, other than on an anonymous basis through a US exchange (or other unaffiliated intermediary) or through a market intermediary acting as a principal (as long as the trade is cleared through a US clearing counterparty).

Compliance

Similar to the proposal, the rule sets out six components[8] as the baseline requirement for compliance programs of banking entities with more than $10 billion in consolidated assets.[9] These banks are also subject to the *enhanced* compliance program – including CEO certification – if their consolidated assets are greater than $50 billion, or if their trading assets and liabilities exceed a certain threshold (phased-in over three years).[10] The phase-in starts in 2014 for banks that have $50 billion or more in trading assets and liabilities, and ends in 2016 for banks with greater than $10 billion in trading assets and liabilities.

CEO certification

The final rule introduces the requirement that bank CEOs annually certify to the effectiveness of their compliance programs.[11] Although bank CEOs will not be required to certify that their organizations are in compliance with the rule, they must certify that their compliance processes are reasonably designed (e.g., effective policies and procedures are in place) to achieve compliance with the rule.

As a result, banks must develop the appropriate framework for effective and timely certification, which will demand compliance and operational changes, but banks may leverage their existing frameworks and processes to meet the new requirement. For large and complex banks, the appropriate framework will likely include a sub-certification processes that starts at the desk, moves to the head of the business unit, and ultimately reaches the CEO.

These banks should consider leveraging their existing compliance certification framework to integrate this certification process. The internal audit department can also assist in evaluating and testing the design and operating effectiveness of the certification process, as well as the underlying compliance controls.

Metrics

Under the final rule, the number of reporting metrics for determining whether trading activities are appropriate has been reduced from 17 to seven. These remaining seven are more relevant to making this determination, particularly with respect to the market making and hedging exemptions. The seven include:

- Risk and position limits and usage
- Risk factor sensitivities
- Value-at-risk ("VaR") and stress VaR
- Comprehensive profit and loss attribution
- Inventory turnover
- Inventory aging
- Customer facing trade ratio – trade count based and value based

Calculating and reporting the metrics according to the standardized specifications described in the final rule will require banking entities to implement some new processes and will increase compliance costs, but the burden appears manageable. Most of the metrics are consistent with current risk management of trading desks, and the rule does not prescribe specific targets for these metrics (which is consistent with the final rule's theme of supervisory discretion).

Finally, in addition to these specific metrics, the rule calls for banking entities to develop and implement additional metrics that are tailored to the particular strategies and risks of its trading desks. These metrics are to be developed at the trading desk level and may be based on types of instruments traded, trading activities and strategies, and history and experience (e.g., whether the trading desk is an established, successful market maker or a new entrant). Banks should monitor and analyze these metrics on an ongoing basis and escalate instances of heightened risk within the banking entity for proper action, e.g., further analysis, explanation to regulators, and remediation.

The largest banks have some quick work to do. Those with trading assets and liabilities of over $50 billion (13 institutions) are required to start reporting metrics on June 30, 2014.

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[8] These components include (a) written policies and procedures that establish trading and exposure limits for the activities conducted by the bank, and are designed to ensure compliance, (b) internal controls, (c) a management framework that delineates compliance responsibility and accountability, (d) independent testing and audit, (e) training, and (f) recordkeeping.

[9] Concurrently with the final rule, the banking regulators issued a guidance letter on the applicability of the rule to banks with less than $10 billion in consolidated assets ("community banks"). According to the letter, community banks are generally exempt from compliance requirements as long as they do not engage in prohibited covered activities under the rule. For those community banks that do engage in covered activities, the compliance program requirements can be met by simply including references to the relevant portions of the rule within the bank's existing policies and procedures to address just the activities that the bank actually conducts.

[10] For foreign firms, the calculation is limited to their US operations.

[11] For US operations of a foreign bank, the certification may be provided by the senior management officer of the US operation who is located in the US.

Covered funds

The final rule implements the statutory provision prohibiting a banking entity from acquiring and retaining an ownership interest (directly or indirectly) in a covered fund or having certain relationships with a covered fund. The final rule makes a number of significant changes from the proposal that are favorable to the industry – most importantly, narrowing the definitions of covered fund and trustee. However, the industry's hopes for changes to the proposed limitations on covered fund transactions (i.e., Super 23A) were not met.

Narrowed definitions

Covered fund definition

The rule adopts a narrower definition of covered fund that is more tailored to the activities of hedge funds and private equity funds. Most notably, the new definition now excludes foreign public funds and certain loan securitization vehicles, which had been included in the proposed rule:

- **Foreign public funds.** To be excluded, these funds must generally have the same characteristics as US mutual funds (which have been excluded from the definition's scope since the proposed rule), including authorization to sell to retail investors and being sold primarily through a public offering.
- **Loan securitization vehicles that are comprised only of loans and related servicing assets.**[12] These vehicles are exempt, but all other types of securitizations, including securitizations of securities (e.g., CDOs and municipal securities) or other assets (e.g., real estate or intellectual property) remain largely covered by the rule.

The exclusion of foreign public funds from the covered fund definition, like the more favorable treatment of sovereign debt with respect to trading activities (discussed earlier), is a gain for foreign markets and restores parity between US and non-US funds. While US mutual funds were excluded from the proposed rule, their foreign counterparts (such as UCITS funds in Europe) had been caught as covered funds. Now, that disparity has been eliminated.

However, the new exclusion for loan securitization vehicles appears to be of less utility to market actors. Some issuers will find it difficult to take advantage of the exclusion because their securitization vehicles may include even a small percentage of ineligible underlying assets. We have already seen instances of banking entities refusing to share in the ownership of such "tainted" funds. Furthermore, the exclusion requires continued documentation and proof that no ineligible underlying assets are included in the vehicle.

A third important change to the covered fund definition is that many commodity pools have been excluded, where the proposed rule had categorized all commodity pools as covered funds. Only those commodity pools that use the CFTC's Rule 4.7 exemption[13] remain subject to Volcker (as do commodity pools with similar characteristics). This narrowing of the definition is particularly meant to target the otherwise hard-to-define hedge and private equity funds.

Recognizing that the proposed rule captured many investment entities that did not pose the same risks as hedge funds and private equity funds, the final rule excludes many more entities from being covered funds.[14] These exclusions include non-US pension plans, insurance companies separate accounts, and bank-owned life insurance separate accounts. Furthermore, clarification in the final rule removes any doubt that entities relying on exemptions to the Investment Company Act besides 3(c)1 and 3(c)7, such as US pension plans using 3(c)11 relief, are not considered covered funds. The rule also allows the Agencies to exclude additional entities from the covered fund definition.

Trustee definition

The rule also narrows the definition of trustee. Many funds (particularly in foreign jurisdictions) are legally required to have a trustee, which is a service that many banking institutions provide. The proposed rule considered this trustee relationship to be "sponsorship" of the fund (rendering the fund a covered fund), although the entity had no investment discretion in the funds. Now trustees that perform primarily a fiduciary duty but do not have investment discretion or general authority to replace the investment adviser are not considered fund sponsors. Therefore, banks can engage in more trustee services than contemplated under the proposal.

[12] This exclusion applies to loan securitization vehicles that hold only permitted assets: (a) loans (excluding CLO notes, bonds, and credit derivatives), (b) limited contractual rights or assets arising from the securitization, and (c) FX and interest rate derivatives that relate materially to the terms of the loan.

[13] CFTC's Rule 4.7 provides an exemption from registration requirements to operators of those commodity pools whose participants are limited to "qualified eligible persons," i.e., savvy investors or non-US persons.

[14] While many of these exclusions were exemptions from activity restrictions in the proposed rule, the final rule excludes the activity from even being a covered fund.

Super 23A limitations on relationships with a covered fund

The proposed rule prohibited a banking entity that, directly or indirectly, serves as investment manager, investment adviser, or sponsor to a covered fund (or that organizes and offers a covered fund pursuant to the final rule) from entering into a transaction with a covered fund that would be a "covered transaction" as defined in section 23A of the Federal Reserve Act. However, the proposal failed to incorporate exemptions provided under section 23A or the Federal Reserve's Regulation W, which resulted in the proposal's provision being labeled "Super 23A." The industry strongly objected to this unbalanced application of affiliate transaction restrictions arguing that, due to their low risk, section 23A exemptions should be available for intraday credit transactions, transactions secured by cash or US Government securities, and riskless principal transactions (among other exemptions).

In a surprise to many, the Agencies did not change their interpretation in the final rule, taking the view that the statute itself failed to include the section 23A exemptions by its terms. Hence, Super 23A lives. In so doing, the Agencies took the view that by narrowing the definition of covered funds and proprietary trading, they had eliminated the most troublesome of the perceived problems with Super 23A.

The Agencies, in the preamble, also took the liberty of offering their interpretations of some related issues under Super 23A:

- A banking entity that delegates its responsibility to act as sponsor, investment manager, or adviser to an unaffiliated third party will still be subject to Super 23A if it retains the ability to select, remove direct, or otherwise control the designee.
- Super 23A does not apply to transactions that are not with a covered fund, such as extending credit to a third party secured by shares of a covered fund.

Offered for sale or sold to a resident of the United States

As was the case with the SOTUS trading exemption (discussed earlier), the Agencies abandoned their proposed transaction-by-transaction approach to determining what qualifies for exclusion as an investment or sponsorship by a foreign bank in a foreign covered fund solely outside the US, in favor of a risk-based approach focusing on the location of principal risks. Specifically, the final rule provides that an activity or investment occurs solely outside the US if:

- The banking entity is not located in the US or organized under federal or state law. The rule's preamble provides that any US branch, agency, or subsidiary of a foreign bank is considered to be located in the US.
- The banking entity (or its personnel other than back office staff) that makes the decision whether to sponsor or acquire an ownership interest in covered fund is not located in the US or organized under US law.
- The investment or sponsorship is not accounted for as principal by any branch or affiliate located in the US.
- No financing is provided by a US branch or affiliate.

The final rule does not prohibit a foreign banking entity from investing in or sponsoring a foreign covered fund if there is no offer for sale or a sale to a US resident. The rule provides that an offer or a sale to a US resident pertains only to an offering that targets residents of the US. The definition of US resident is changed to be the same as under SEC Regulation S.

What banks should be doing now

As discussed in our previous regulatory briefs,[15] we have observed market participants at various stages of preparedness during the "good faith" conformance period. However "good faith" must now be replaced with real action. You don't prop trade? *Prove it*. Those hedges mitigate certain risks? *Show the correlation*. "Demonstrate" is the key word.

While the most advanced banks are already collecting some metrics, there is still a significant amount of work to be done. Banks must act now in order to prepare to meet their metrics reporting and compliance program obligations:

Size (in trading assets and liabilities)	**Compliance deadline**
$50B or more	**June 30, 2014** • Metrics reporting **July 21, 2015** • Enhanced compliance program*
$25B – $50B	**July 21, 2015** • Programmatic compliance program **April 30, 2016** • Enhanced compliance program • Metrics reporting
$10B – $25B	**July 21, 2015** • Programmatic compliance program** **December 31, 2016** • Enhanced compliance program • Metrics reporting

* Also applies to banking entities with $50 billion or more in consolidated assets.

** Also applies to banking entities with $10 billion or more in consolidated assets.

Whether or not a banking entity is required to report metrics under the compliance deadlines in the above table, metrics are a key barometer for assessing compliance with the rule – in other words, metrics will likely be viewed as a needed component of an effective enhanced compliance program that CEOs will have to certify to.

The following are the major components of a compliance action plan:

Conduct/resume a business impact analysis

Banking entities need to understand which of their businesses, products, and regions are at risk under the final rule. To do so, they must determine or reassess how the final rule will impact trading activity, revenues, and costs across all of their businesses globally. Banks should:

- Analyze the size of their trading assets and liabilities to identify when quantitative metrics reporting and enhanced programmatic compliance standards begin.
- Inventory all trading desks and assess the impact of the rule on the activities of those desks based on the products being traded, hedging strategies, source of revenues, and scope of activities conducted within/outside of the US.
- Design a strategic approach for demonstrating how the activities within each trading desk align with the permitted activities contained within the rule.
- Analyze investments in or transactions with covered funds, and determine next steps for addressing issues identified, e.g., whether activities can be continued under an exemption or the bank must divest.
- Consider 23A restrictions.

Design and build a metrics reporting strategy

The largest banks will have to begin reporting the seven prescribed metrics starting on June 30, 2014, while the remaining banks will be phased-in during 2016. Preparation for metrics reporting includes:

- Decomposing/recomposing business units into reporting clusters (e.g., grouping of like desks/trading units into reporting groups based on business activity).
- Developing the required reporting data dictionary and assessing the availability of data in source systems.
- Working with business leads, desk heads, and business managers to develop data requirements/attribute definitions and calculation methodologies.
- Reviewing current business management metrics and reports to understand current capabilities that could be leveraged.
- Developing an IT strategy, budget, and implementation plan.
- Piloting the metrics reporting approach.
- Determining what additional metrics should be reported as part of the banking entity's enhanced compliance program standards.

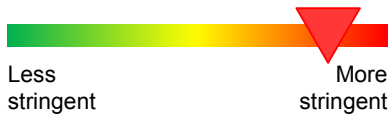
Prepare for the minimum and enhanced standards of compliance

Banking entities must be able to demonstrate their compliance with the rule's permitted activities at the expiration of the conformance period. The largest banks will also have to comply with the enhanced standards at that time, while the remaining banks will be phased in during 2016. At a minimum, banks will need to produce the following information:

- A Target Operating Model ("TOM") describing the controls, surveillance, monitoring, testing, strategy, people, processes, and technology needs including achieving consensus and buy-in on the governance model globally.
- An overview of the Volcker program approach including governance structure.
- A description of how management has defined key Volcker terms, such as prohibited and permitted trading, in order to develop their institution-specific view of Volcker, and a description of how that information is disseminated to impacted business units.
- Internal controls, policies and procedures, and a process for independent testing to demonstrate compliance with the market making, hedging, underwriting, and other permitted activities.
- Documentation, in particular for hedging, sufficient to demonstrate compliance with the rule requirements.
- An analysis of the expected impact of the rule on the banking entity's business, including the impact on revenues, customer relationships, risk profile and ability to manage risk, and the additional costs of compliance.
- Documentation supporting the identification and exclusion of covered funds.
- An inventory of existing funds and investments, and an analysis of the impact of the rule's covered fund provisions on them.

[15] See note 4.

Appendix – Major changes from proposed to final rule

	Proposed rule	Final rule	Outcome
Overall approach	• Transaction-based, "one size fits all" framework • Required controls at trading unit level	• Risk-based, "safety and soundness" approach that relies on banks to design, implement, and administer controls • Requires more granular control focus at the trading desk level	
Hedging	• Distinguished between market making, hedging, and risk mitigating hedging with different criteria	• Focuses primarily on risk mitigating hedging • No longer considered a distinct and separately identifiable activity within market making • More focus on demonstrating hedge effectiveness	
Trading activities of a foreign banking entity	• Defined US nexus broadly as activity: conducted in US-based legal entities, conducted or supported by US personnel, generating revenue from US clients, or executed on US exchanges	• Consistent with CFTC's cross border guidance on US personnel involvement • Permits foreign banking entities to purchase from or sell to the foreign operations of a US entity	
Trading in government obligations	• Allowed proprietary trading only on US obligations and municipalities	• Permits a US branch or agency of a foreign bank to proprietary trade in home country's sovereign debt • Permits non-US affiliates of a US bank to proprietary trade the sovereign debt of the affiliate's host country	
Liquidity management	• Permitted *bona fide* liquidity management activity • Required documented liquidity management plan	• Clarifies that liquidity management does not include ALM activity or ALM hedging activity	
Quantitative measurements	• 17 metrics across five categories reported at trading unit level across all desks / trading units	• 7 metrics across 3 categories • Calls for additional metrics tailored to a desk's particular risks, practices, and strategies	
Compliance program	• Required robust programmatic compliance program in six areas	• Introduces tiered compliance requirements based on gross trading assets and liabilities • Enhanced program requires annual CEO attestation on the compliance program's design and effectiveness	

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Additional information

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