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Financial Institutions Regulation Group Client Alert: The Cart before the Horse: How the Volcker Rule's Reporting Requirements Accelerate Volcker Rule Implementation and Compliance

I. Introduction

The recently adopted Volcker Rule contains two provisions, § _.20(d) and Appendix A, that mandate the first effective compliance requirements of the Volcker Rule.[1] These provisions require detailed periodic reporting by July 30, 2014, of various risk and inventory metrics by large banking entities that have significant trading assets and liabilities (the "Reporting Requirements"). While the Volcker Rule prohibition on proprietary trading does not take effect until June 2015 at the earliest (unless otherwise extended), large banking entities must report "quantitative metrics" on their "covered trading activities," such as permitted market-making, almost a full year earlier – they must report by July 2014 data reflecting trading for the month ending June 30, 2014. This curious situation results from the decision by the Federal Reserve to delay implementation of the substantive Volcker Rule provisions one additional year, from June 30, 2014, to June 30 2015, but not to delay the reporting requirements.[2] Since one of the purposes of the reporting requirements is to allow the Agencies to evaluate whether large firms are conducting their market-making activities consistent with the market-making exception to the proprietary-

[1] *See generally* Prohibition 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) (codified at 12 C.F.R § 44 (OCC); 12 C.F.R. § 248 (Federal Reserve), 12 C.F.R. § 351 (FDIC), 17 C.F.R § 255 (SEC)) (the "Volcker Rule Release"). The CFTC simultaneously issued an identical rule. *See generally* Prohibition and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5808 (Jan. 31, 2014) (codified at 17 C.F.R. § 75). This client alert cites to the sections of the Volcker Rule in the Common Rule form published in the Federal Register by the OCC, Federal Reserve, FDIC, and SEC (collectively, along with the CFTC, the "Agencies"). While there are individual citations to each Agency's rule, we do not cite to them in order to maintain the general application to all types of banking entities regulated by all of the Agencies.

[2] *See* Federal Reserve System: Order Approving Extension of Conformance Period at 3 (Dec. 31, 2013), http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.

trading ban,[3] firms required to report metrics during the so-called "conformance period" will delay full implementation of Volcker Rule compliance procedures for market-making at their peril.

The anomalous requirement to report trading desk metrics before the proprietary-trading ban goes into effect evidently was not intended by the Agencies. The lengthy "preamble" to the Volcker Rule discusses comments received on the timing of reporting metrics in the proposed rule (which were substantially more burdensome), including comments that urged allowing banking entities the use of the full conformance period for creating the systems and processes to capture and report the quantitative metrics.[4] Others suggested that metrics should not be required to be reported until one year after adoption of final regulations.[5] Mindful of these arguments, the Agencies "delayed" metrics reporting for the largest firms until June 30, 2014, which was to have been the end of the conformance period. However, with the conformance period extended one year, the most significant banking entities subject to the Reporting Requirements must determine whether they are "engaged in proprietary trading" permitted under the various Volcker Rule exemptions, and then report metrics relating to the activity of trading desks that may not yet be organized in the manner required by the Volcker Rule. These large banking entities must report on "covered trading activities" even though such activities are not "covered" by any substantive rule prior to the extended conformance date of the Volcker Rule, and they must report trading data for a Volcker-compliant world that will not exist for another year (and perhaps longer if the conformance date is again extended).

As a result, banking entities subject to the Reporting Requirements in July 2014 do not have the benefit of the extended June 2015 Volcker Rule implementation date. These entities must promptly begin to (i) assess their business lines and trading desks for compliance with the Volcker Rule and develop the rigorous compliance and procedure-based infrastructure required for many of its exemptions (that is, conduct a "Volcker Assessment"), (ii) develop and implement a daily monitoring and monthly reporting system, and (iii) design and implement extensive, new written supervisory procedures for compliance with both the Reporting Requirements and Volcker Rule's substantive requirements. This is no small task, which is why the Agencies extended the initial Volcker Rule compliance date into 2015.[6] But for the largest banking entities, perhaps with the most daunting work ahead of them, the date for compliance is just six months ahead.

Below, we discuss the key issues arising from the Reporting Requirements, including conducting a Volcker Assessment, preparing for accelerated compliance with the

[3] *See* Appendix A, Subsection I.B.4.
[4] *See* Volcker Rule Release at 5763 and FN.2667 (citing the following comment letters: "BoA; Barclays; Citigroup (Feb. 2012); Goldman (Prop. Trading); JPMC; Morgan Stanley; SIFMA et al. (Prop.Trading) (Feb. 2012); UBS; Stephen Roach").
[5] *See id*. and FN 2668 (citing the following comment letters: "Credit Suisse (Seidel); JPMC; Wells Fargo (Prop. Trading)").
[6] *See* Order Approving Extension of Conformance Period at 2 (explaining that banking entities need to conform their trading activities to the Rule in a "safe and sound" manner).

Volcker Rule to meet the Reporting Requirements, and analyzing some open issues and inconsistencies with the Reporting Requirements.

II. Which Banking Entities are Subject to the Reporting Requirements?

The Reporting Requirements will be phased in from June 30, 2014, to December 31, 2016, with banking entities that have "trading assets and liabilities" of at least $50 billion subject to the earliest threshold. Banking entities' "trading assets and liabilities" are measured differently for U.S. and foreign banking entities. For **U.S. banking entities,** their world-wide trading assets and liabilities, including those of affiliates and subsidiaries, count toward the threshold. For **foreign banking entities,** only the trading assets and liabilities of **U.S. operations** (including U.S. subsidiaries, affiliates, branches and agencies) count toward the threshold.[7] The threshold is calculated for both foreign and U.S. entities as the average gross sum of trading assets and liabilities over the past four quarters, excluding U.S. Treasuries.

Banking entities with trading assets and liabilities of $50 billion or more must begin reporting on June 30, 2014 ("Early Reporters").[8] It is estimated that a dozen banking entities, six domestic and six foreign, will meet the $50 billion threshold.[9] The threshold for reporting decreases to $25 billion on April 30, 2016, and to $10 billion at the end of 2016 and would therefore capture more reporting entities.

Note that that $50 billion threshold is measured by **trading** assets and liabilities, and not by consolidated assets as is used in other parts of the Volcker Rule. Further, the "trading assets and liabilities" are measured not on a static basis, but on a rolling-average basis. Thus, the formula for "trading assets and liabilities" is the average gross sum of (if applicable, U.S.) trading assets and liabilities, excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency thereof, on the last day of each of the four previous quarters.[10] Reports must be made on a monthly basis, initially within 30 days from the end of the applicable calendar month. Since the threshold for Early Reporters is first triggered on June 30, 2014, the first month for which a report must be made is July 2014. Given that the report is due within 30 days of the subject calendar month, the first report by Early Reporters is due on August 30, 2014.[11] Accordingly, the largest U.S. banks with trading desks (regardless of where their trading desks are around the world), and foreign banking entities with significant trading desks in the

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[7] § _.20(d)(1)(ii).

[8] §§ _.20(d)(1)(i); _.20(d)(2). U.S. treasuries are excluded from the calculation of trading assets and liabilities.

[9] *See* John Ramsay, Acting Director, SEC Division of Trading and Markets, Address at the Association of the Bar of the City of New York, Committee on Futures and Derivatives: The Volcker Rule and Market Making (Feb. 4, 2014). Mr. Ramsay stated that all statements and opinions were his own and not attributable to the SEC.

[10] § _.20(d)(1)(i).

[11] Volcker Rule Release at 5772.

U.S., must comply with the Volcker Rule's reporting requirements nearly one year before the Rule's delayed effective date of July 21, 2015.[12]

III. What Activity Must Be Reported?

The text of Appendix A raises a number of inconsistencies about which types of trading activity need to be reported. That is, once a banking entity becomes subject to the Appendix A Reporting Requirements, does it need to report metrics with respect to: (a) all of its proprietary trading activity? (b) trading activity permitted under Volcker exceptions? (c) proprietary trading activity that falls outside the Volcker Rule not pursuant to an exemption but because it is not for a "trading account" or in a "financial instrument"? or (d) trading activity of a foreign banking entity outside the US (after all, non-US trading assets and liabilities are excluded from the $50 billion reporting threshold)?

Certain of these points are unclear, due to an inconsistency between language in the substantive Reporting Requirements in Appendix A and Appendix A's less binding "Purpose" statement that precedes the substantive requirements. We address this inconsistency and other issues with the Reporting Requirements in more detail below.

a. Inconsistency between "Covered Trading Activity" and "All Trading Activity"

Subsection I of Appendix A sets forth its "Purpose." Among other things, it describes the purpose of the Reporting Requirements as to assist the Agencies in "[b]etter understanding and evaluating the scope, type, and profile of the banking entity's covered trading activities."[13] The term "covered trading activity", which is defined in Section II of Appendix A, is used exactly eleven times in Appendix A, but appears only in the purpose and in its definitions. Notably, the term does not appear in, and therefore does not appear to qualify the application of, any of the substantive Reporting Requirements that are set forth in Section III of Appendix A.

The substantive Reporting Requirements (as contrasted with the "Purpose" section) states that "[e]ach banking entity subject to this part . . . must furnish the following quantitative measurements for each trading desk of the banking entity."[14] The specific language here is important. The requirement is not to report "for each trading desk *conducting a covered trading activity*", but simply to report "for each

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[12] *See* Order Approving Extension of Conformance Period at 3.

[13] The term "covered trading activity" by itself raises an issue when comparing the July 2015 Volcker Rule implementation date against the June 2014 implementation date for the Reporting Requirements. During the period from June 2014 to July 2015 the Volcker Rule will not be in effect and, as such, no trading activity technically is "covered" by the Volcker Rule. Given that the Agencies did not extend the Conformance Date for the Reporting Requirements, it is clear that the Agencies expect subject banking entities to report during this period. This inconsistency is best reconciled by the fact that banking entities remain within the Conformance Period and accordingly should report as if their activities were "covered" and as if the Volcker Rule were fully in effect.

[14] Appendix A, Subsection III.A, Scope of Required Reporting.

trading desk."[15] This suggests that once a banking entity is subject to Appendix A, it must report the required metrics for all of its trading desks and not just for the trading desks that engage in a covered trading activity. This reading is not only certainly inconsistent with Appendix A's title[16] and the purpose of the Appendix A reporting requirements, but also with the Preamble to the Volcker Rule, which states that banking entities must report "metrics for all trading desks engaged in covered trading activity."[17]

It seems appropriate, notwithstanding the plain language of the requirement, to attribute the language to unclear drafting and to report only with respect to "covered trading activities." To avoid problems with overzealous examiners, the Agencies should provide guidance sooner rather than later on this crucial point.

b. Determining and Reporting "Covered Trading Activity"

Presuming that the Reporting Requirements apply only to "covered trading activities" when such activities will in fact be covered by the Volcker Rule, in order to report on covered trading activities a Reporting Entity must first determine the covered trading activities in which it engages. This requires the banking entity to conduct a Volcker Assessment – an analysis of each desk engaged in principal trading activity against the Volcker Rule's prohibition and exceptions – to determine the Volcker exemption under which the trading desk's activity falls. Appendix A defines two types of covered trading activities: (a) trading activities that are truly "covered trading activities" and are required to be reported under Appendix A and (b) trading activities that a banking entity "may include under" Appendix A. The "required" covered trading activities are those undertaken pursuant to the following Volcker exemptions: (i) underwriting (§ _.4(a)), (ii) market making (§ _.4(b)), (iii) risk mitigating hedging (§ _.5), and (iv) trading in domestic (§ _.6(a)) and foreign (§ _.6(b)) government obligations.[18] Covered trading activities are determined on a "trading desk" basis. Thus, a banking entity must identify the smallest discrete units that perform these types of trading in order to begin monitoring, recording, and reporting on those trading desks' activity. The "permissive" covered trading activities (which a banking entity may, but is not required to, report) are (i) all trading excluded from the Volcker Rule's definition of proprietary trading (§ _.3(d)),[19] (ii) trading on behalf of customers, including fiduciary transactions and riskless principle trading (§ _.6(c)), (iii) trading by a

[15] Appendix A defines a "trading desk" as "the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof."
[16] "Appendix A: Reporting and Recordkeeping for Covered Trading Activities". Appendix A.
[17] Volcker Release at 5764 (emphasis added).
[18] Appendix A, Subsection II, Definitions.
[19] These include trading pursuant to repurchase and reverse repurchase agreements, securities lending, trading pursuant to qualified liquidity management plans, trading by a derivatives clearing organization or clearing agency in connection with clearing financial instruments, trading by a banking entity acting as an agent, broker or custodian, trading related to qualified employee benefit plans of the banking entity, and others. *See* § _.3(d).

regulated insurance company (§ _.6(d)), and (iv) trading outside the United States (the "TOTUS"™ exemption, § _.6(e)).[20]

Whether a trading activity must be reported, or may be included, turns on the type of Volcker exemption. Thus, when a banking entity can avail itself of more than one type of exemption, it should consider the reporting requirement pertaining to each applicable exemption. The different treatment of these exemptions can provide a banking entity with different reporting options. For example, a banking entity with a desk that trades outside the United States might debate whether to comply with the TOTUS exemption of § _.6(e) or, for business considerations, to comply with the market-making exception. In making that decision, the banking entity may want to consider any additional reporting burden under Appendix A. Regardless, given the short timetable for compliance with the Reporting Requirements, Early Reporters must begin to assess their trading activity and make these types of decisions in the near term.

c. Volcker Assessments – The Time is Now

Because quantitative measures must be reported at the trading-desk level, banking entities, foreign and domestic, must begin to assess covered trading activity not only at the entity-wide level, but also at the trading-desk level. Accordingly, foreign and domestic banking entities need to begin to thoroughly assess and identify various trading activities across their trading desks based upon the categories identified in the Volcker Rule. Additionally, Early Reporters should design, develop, and implement systems to monitor and record the data required to calculate the quantitative measurements mandated by the Reporting Requirements. These systems will need to operate at the granular, trading-desk level, and not at the entity level.

IV. Early Compliance with the Volcker Rule by Reporting Entities

Appendix A's Reporting Requirements, and monitoring of the trading activity subject to those requirements, effectively obligate Early Reporters to comply with the substantive provisions of the Volcker Rule prior to the final conformance date of July 21, 2015. Against that backdrop, we review the Reporting Requirements and how they effectively mandate substantive compliance with the Volcker Rule.

a. Summary and Review of Reporting Metrics

Appendix A requires subject banking entities, at the trading-desk level, to compile the following information relating to covered trading activities:

- Risk Management Measurements. These metrics include (i) risk position limits and usage; (ii) risk factor sensitivities; and (iii) VaR and Stress VaR calculations.

[20] Appendix A, Subsection II, Definitions.

- Source-of-Revenue Measurements: This requires a daily analysis, and monthly reporting, of P&L fluctuations, attributing any profit or loss to (i) positions existing at the end of the prior trading day; (ii) positions resulting from the current day's trading activity; or (iii) residual activity; that is, profit or loss that cannot be specifically attributed to existing or new positions.

- Customer-Facing Activity: This metric requires calculation and reporting, on a trading desk basis, of (i) inventory turnover, (ii) inventory aging, and (iii) customer-facing trade ratio (*i.e.*, the ratio of transactions with counterparties who are customers versus transactions with counterparties that are not customers).[21]

These metrics impose a substantial burden on Early Reporters. Not only do they need to develop systems very quickly to capture and calculate the relevant metrics,[22] but they also need to evaluate and then organize their trading desks in a manner consistent with the covered trading activity those desks will conduct. Moreover, because many of the metrics and the terms used within their definitions are so closely tied to the substantive requirements of the Volcker Rule and the corresponding exemptions, evaluating those terms and metrics under the Reporting Requirements will necessarily require evaluating those same terms under, and complying with, the Volcker Rule and its exemptions. The next section contains a few examples.

b. Select Reporting Requirements and Overlap with Substantive Provisions and Volcker Rule Exemptions

Below we examine two examples of Reporting Requirements and how they intersect with the substantive provisions of the Volcker Rule and relevant Volcker exemptions.

i. Risk Position Limits

Appendix A requires subject banking entities to report each trading desk's risk limits and the amount of those risk limits that the applicable trading desk uses. Setting risk limits is not simply a Reporting Requirement, but a complex provision of the Market-Making, Hedging, and Underwriting exemptions in § _.4 and § _.5. As a result, a Reporting Entity cannot report a trading desk's risk limits and usage without first establishing and enforcing those limits, as applicable, pursuant to those exemptions. Therefore, in order to comply with the mandated Reporting Requirements on time, a Reporting Entity must establish, implement, evaluate, and enforce these trading limits before June 2014.

[21] Appendix A, Subsection IV.

[22] The Agencies addressed this fact in the Preamble, claiming that banking entities already collect much of this information. *See* Volcker Rule Release at 5772. Even if that were the case, it is not clear whether banking entities collect such data at a trading desk by trading desk basis or if they have organized such trading desks.

Simply establishing such limits is not nearly enough. Under the substantive provisions of the relevant Volcker exemption, a banking entity is required to analyze and monitor its limits on an ongoing basis, set escalation procedures for when they are exceeded, and adopt an internal compliance program and written supervisory procedures with respect to them. This is clearly a lot to accomplish, for each applicable trading desk, within the next few months.

ii. Inventory Analysis and Trading with "Customers"

Appendix A requires significant analysis of a trading desk's inventory. As indicated, each trading desk must evaluate and report its inventory turnover and aging. These requirements cannot be evaluated in a vacuum but must be considered along with other Volcker inventory-related requirements. For example, the Market-Making exemption requires a trading desk relying upon that exemption to evaluate its "market-maker inventory" on an ongoing basis to confirm that it is designed not to exceed the "reasonably expected near term demands of clients, customers, or counterparties."[23] The age and turnover of market-making inventory will be relevant in analyzing whether the desk's inventory exceeds reasonably expected near-term demands. For example, the longer that financial instruments have remained in the inventory, the harder it is to argue that the amount of the financial instruments in the inventory is designed to meet near-term demands of customers.

Appendix A also requires each trading desk of banking entities to calculate the ratio of the frequency at which it trades with "customers" against the frequency at which it trades with non-customers. For these purposes, a counterparty is a "customer" of the trading desk if it makes use of the trading desk's market-making services.[24] This definition in Appendix A must be reconciled with the definition of "client, customer, or counterparty" in the substantive market-making provisions of the rule. Under the market-making exception, a trading desk or organizational unit of a banking entity with trading assets and liabilities equal to or exceeding $50 billion cannot be a client, customer, or counterparty of the market-making desk unless the trading desk can document how and why that organizational unit should be treated as a customer.[25] The same analysis applies in determining, under the Reporting Requirements, whether a transaction is with a "customer."

V. Conclusion

The banking entities initially subject to the reporting requirements of Appendix A are the "largest banking entities" that "engage in significant trading activity."[26] Accordingly, these banking entities will have to undertake the "largest" and most "significant" efforts to comply with § _.20(d) and Appendix A. These efforts must be completed before June 30, 2014, when such banking entities must begin reporting under Appendix A. In order to address the Volcker Rule reporting requirements and other implicated provisions, large banking entities should promptly conduct Volcker

[23] § _.4(b)(2)(ii).
[24] Appendix A, Subsection IV.C.7.
[25] § _.4(b)(3).
[26] Volcker Rule Release at 5764.

Assessments that thoughtfully (i) consider the Volcker Rule in full, (ii) identify the particular trading categories listed in §§ _.3-.6, (iii) address many of the requirements of those sections and Appendix A, (iv) develop monitoring and reporting systems at the trading-desk level, and (v) design an effective Volcker Rule compliance program. Unfortunately for Early Reporters, being a year early is being "on time."

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