



# Volcker Rule Study Recommends Implementation of a Comprehensive Proprietary Trading Compliance Framework

January 2011

**C L I F F O R D**  
**C H A N C E**

Attorney Advertising  
Prior results do not guarantee a similar outcome.

On January 18th, 2011, the Financial Stability Oversight Council (the "Council") published a *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds* (the "Study"). The Study was conducted pursuant to the requirements of Section 619 (commonly referred to as the "Volcker Rule") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and its principal purpose was to provide implementation recommendations to the regulatory agencies responsible for implementing the provisions of the Volcker Rule.<sup>1</sup>

This note outlines the principal aspects of the Council's recommendations on implementing the Volcker Rule's proprietary trading ban. As more fully discussed below, the Study contains helpful suggestions for distinguishing prohibited proprietary trading from market making, hedging, and other permitted activities. At the same time, however, the Study recommends the implementation of a compliance regime of significant complexity. Notably, the Study also suggests that the CEOs of banking entities subject to the Volcker Rule ("covered entities") be required to publicly attest that compliance standards are continually being met.

The Agencies are required under the Dodd-Frank Act to promulgate regulations implementing the Volcker Rule no later than October 21, 2011, taking into account the recommendations made in the Study. The Study is not binding on the Agencies. It does provide a framework, however, with which the Agencies are likely to work when drafting implementing regulations. And, even though much of the work on implementing the Volcker Rule lies ahead, the Study provides indication about the direction the rulemaking process is likely to take.

## General Implementation Principles

The Study generally recommends that the implementation of the proprietary trading prohibitions of the Volcker Rule should be guided by the following principles:

- The implementing regulations should ensure that improper proprietary trading is detected and prohibited using all necessary tools, including through a programmatic compliance regime and examination resources.
- The Agencies should implement rules and supervisory processes that are dynamic and flexible to be able to understand and address evolving products and market trading activities.
- The rules and supervisory standards should be consistent and enable comparison among banking entities.
- The rules and supervision framework should account for differences among asset classes.
- The implementing rules should enable the Agencies and covered entities to

-----  
If you would like to know more about the subjects covered in this publication or our services, please contact:

**David Felsenthal** +1 212 878 3452

**Thomas Pax** +1 202 912 5168

**Jeff Berman** +1 212 878 3460

**Philip Angeloff** +1 202 912 5111

To email one of the above, please use  
firstname.lastname@cliffordchance.com

Clifford Chance, 31 West 52nd Street,  
New York, NY 10019-6131, USA  
[www.cliffordchance.com](http://www.cliffordchance.com)

-----

<sup>1</sup> The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (collectively, the "Agencies").

determine what constitutes a prohibited and a permitted trading activity to facilitate regulatory certainty.

## **Bright Line Test and Indicia of Permitted Trading**

The Study acknowledges and discusses the challenges in delineating proprietary trading from market making, hedging, underwriting, and other permitted activities. To address the issue, the Council recommends that the Agencies: (i) develop a "bright line" test to identify proprietary trading; and (ii) develop indicia of permitted market making, hedging, and underwriting activities in a guidance that will assist covered entities in determining what constitutes permitted trading activity.

The suggested key element of the "bright line" test is whether the trading activity is conducted with proprietary funds of the covered entity and is conducted for the purpose of benefiting from future price movements. In addition, the "bright line" test may be based on one or more of the following characteristics:

- organized to conduct trading activities for the sole purpose of generating profits from trading strategies;
- no formal market making responsibilities or customer exposure (or customer exposure that is not commensurate with the level of trading);
- physical and/or operational separation from market making and other operations having customer contact;
- trades with or is provided the services of, sell side analysts, brokers, and dealers;
- receives and utilizes research or soft dollar credits provided by other broker-dealers; and/or
- compensation structures similar to those of hedge fund managers and other managers of private pools of capital.

## **Comprehensive Proprietary Trading Compliance Framework**

The Council has taken the view that the challenges posed by the difficulty in identifying prohibited proprietary trading activities and the different purposes for which the current risk management framework is designed would require the development of a new supervisory and compliance framework consisting of the following elements:

### **Programmatic Compliance Regime**

The Council recommends that covered entities be compelled to develop a new comprehensive compliance program specifically designed to ensure compliance with the Volcker Rule and to facilitate regulatory oversight. The compliance program may incorporate: (i) a comprehensive set of internal policies and procedures establishing limits, controls, and violation review mechanisms, and guiding permitted trading activity throughout the covered entity by, among other things, including a list of approved products and activities; (ii) internal quantitative and other controls to monitor trading activity to ensure that the types and levels of risk taken are appropriate and consistent with the Volcker Rule policies and procedures; (iii) recordkeeping and reporting systems to facilitate internal and supervisory compliance monitoring; (iv) independent testing (similar to those established with respect to Bank Secrecy Act/Anti-money Laundering compliance); and (v) CEO and Board accountability requirements, including mandatory Board/CEO approval and oversight of the compliance program and public attestation to the ongoing effectiveness of the internal compliance program.

### **Analysis and Reporting of Quantitative Metrics**

The Council recommends that the Agencies consider requiring covered institutions to report quantitative metrics to the Agencies. The Study provides specific examples and describes in detail potential metrics, which would involve fairly complex calculations and rigorous data collection, including the following: (i) revenue-based metrics generally measuring daily revenue and revenue from specific trades relative to historical revenue and similar data from other covered entities; (ii) revenue-to-risk metrics generally measuring revenue generated per unit of risk assumed; (iii) inventory metrics to assess inventory turnover and aging; and (iv) customer-flow metrics measuring the volume of customer-initiated orders against orders initiated by a trader for the purpose of building inventory or hedging.

### **Supervisory Review and Oversight**

The Council recommends that the Agencies strongly consider incorporating some or all of the following supervisory practices in implementing the Volcker Rule: (i) periodic review and testing of internal control procedures; (ii) ongoing monitoring and review of trading activities to identify impermissible trading activities and to inform the scope and frequency of targeted supervisory reviews; (iii) frequent communications with relevant management, trading and control personnel to understand and evaluate specific trading behavior and business models; and (iv) review of quantitative metrics reported by covered entities to identify issues that may require further review and identify prohibited activities or weaknesses in compliance programs.

### **Enforcement Procedures for Violations**

The Council recommends vigorous enforcement mechanisms, including significant supervisory repercussions, termination of activities and investments, and penalties/sanctions for violations.

The Council has strongly recommended that the Agencies implement the proprietary trading compliance framework outlined above. In the Council's view, the elements of the framework are likely to be mutually reinforcing and might be designed to work in concert to constrain proprietary trading *ex ante* and identify potentially problematic trading activity *ex post*. The Council has recognized, however, and has stated that all four parts of the framework may not be relevant or helpful in implementing all aspects of the proprietary trading prohibition, and it may be desirable to place a differing degree of emphasis on each part of the framework, depending on the specific activity or asset class in question. The Council has also stated that the elements of the framework should be viewed by the Agencies as a set of options to choose from in implementing the Volcker Rule in a way that meets the guiding principles set out in the Study.

Considering that the Council is essentially comprised of the heads of the Agencies, it is almost certain that a comprehensive compliance framework for proprietary trading activities will be incorporated in the Agencies' final regulations implementing the Volcker Rule. It remains to be seen, however, to what extent the elements of the suggested framework will be developed and emphasized in the implementation process.

---

This client memorandum does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

[www.cliffordchance.com](http://www.cliffordchance.com)

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ Kyiv ■ London ■ Luxembourg ■ Madrid ■ Milan ■ Moscow ■ Munich ■ New York ■ Paris ■ Prague ■ Riyadh\* ■ Rome ■ São Paulo ■ Shanghai ■ Singapore ■ Tokyo ■ Warsaw ■ Washington, D.C.

\* Clifford Chance also has a co-operation agreement with Al-Jadaan & Partners Law Firm in Riyadh and a 'best friends' relationship with AZB & Partners in India and with Lakatos, Köves & Partners in Hungary.