Experis Finance
ManpowerGroup

Financial Institution Compliance Update

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This communication is designed to provide you with quick snapshots and timely perspective on recent regulatory developments.

Volker Rule: Overview of requirements and what steps banking entities must take to ensure compliance.

Contact us

If you have specific questions regarding the regulatory content and commentary of this message, please contact:
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Background

On December 10, 2013, the five financial regulatory agencies voted to adopt the final Volcker Rule, which bans proprietary trading and restricted investment in hedge funds and private equity by commercial banks and their affiliates. The final rule compliance requirements impacts any banking entity that trades under any of the exemptions to Section 13 of the Bank Holding Company Act of 1956 ("BCH Act").

The Dodd-Frank Act was enacted on July 21, 2010. Section 619 of the Dodd Frank Act added a new BHC Act that generally prohibits banking entities from engaging in proprietary trading, acquiring or retaining an ownership in, sponsoring or having relationships with hedge funds or private equity funds ("covered fund"), subject to certain exemptions. The Final Volcker Rule regulations were released and adopted by the agencies on December 10, 2013, which generally prohibit banking entities from:

- Engaging in short-term proprietary trading of securities, derivatives, commodity futures, and options on these instruments for their own account.
- Owning, sponsoring, or having certain relationships with hedge funds or private equity funds, referred to as 'covered funds.'

As required by Section 619 of the Dodd Frank Act, the final rules, adopted under the BHC Act, provide exemptions for certain activities, including underwriting, market making-related activities, risk-mitigating hedging, trading in certain government obligations, and certain trading activities of

foreign banking entities. Additionally, the final rules exempt for trading on behalf of customers in a fiduciary or riskless principal trade or when acting solely as an agent broker or custodian.

The final rules also prohibit banking entities from owner or sponsoring hedge funds and private equity funds, commonly referred to as "covered funds". There are certain exclusions and permitted activities to these rules such as when the definition of a covered fund include wholly-owned subsidiaries, joint ventures and acquisition vehicles or when the investment includes one of the exemptions (underwriting, market making, etc.).

Overview of Compliance Requirements

The final rule requires banking entities to establish a compliance program regarding compliance with Section 13 of the BHC Act and final rule, including written policies and procedures, internal controls, a management framework, independent testing of the compliance program, training and recordkeeping. The final rule provides compliance requirements that vary based upon the size of banking entity and the amount of activities conducted. This reduces the burden on smaller and less complex entities. Compliance programs and requirements are not applicable to banking entities that do not engage in activities covered by the final rules.

Compliance Program and Final Rule

Subpart D of the final rule requires banking entities that are engaged in covered trading activities to develop and implement a compliance program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on covered trading and fund activities, as per Section 13 of the BHC Act and the final rule. Large banking entities engaged in significant trading activities should establish, maintain and enforce an enhanced compliance program. The enhanced compliance program must:

- Be reasonably designed to identify, document, monitor, and report the covered trading and fund activities and investments of the banking entity; identify, monitor, and promptly address the risks of these covered activities, investments, and potential areas of noncompliance; and prevent activities or investments prohibited by, or that do not comply with, Section 13 of the BHC Act and the rule;

- Establish and enforce appropriate limits on the covered activities and investments of the banking entity, including limits on the size, scope, complexity, and risks of the individual activities or investments consistent with the requirements of Section 13 of the BHC Act and the rule;

- Subject the effectiveness of the compliance program to periodic independent review and testing, and ensure that the entity's internal audit, corporate compliance and internal control functions involved in review and testing are effective and independent;

- Make senior management, and others as appropriate, accountable for the effective implementation of the compliance program, and ensure that the board of directors and CEO (or equivalent) of the banking entity review the effectiveness of the compliance program;

- Facilitate supervision and examination by the Agencies of the banking entity's covered trading and covered fund activities and investments.

The final rule compliance program contains two parts: one that sets forth the enhanced minimum compliance program standards applicable to covered trading activities and one that sets forth the corresponding enhanced minimum compliance program standards with respect to covered fund

activities and investments. If all of a banking entity's activities subject to the final rule involve only covered trading activities (or only covered fund activities and investments), it would be expected that the banking entity would have an appropriate compliance program governing those activities (including an enhanced compliance program if applicable) and it would not be expected that the banking entity would construct the same detailed compliance program under the covered funds (or proprietary trading) provisions of the rule.

Required Documentation

The final rule requires banking entities to maintain documentation to allow the Agencies to monitor their activities for risk of evasion. The Agencies believe that five years is an appropriate minimum period for requiring retention of records to demonstrate compliance with the final rule. The final rule allows the Agencies to require a banking entity to retain records for a longer period if appropriate.

Metrics Reporting Process

Any banking entity that meets relevant thresholds specified in the rule must maintain quantitative measurements for each trading desk engaged in covered trading activity including:

- Risk and Position Limits and Usage;
- Risk Factor Sensitivities;
- Value-at-Risk and Stress VaR;
- Comprehensive Profit and Loss Attribution;
- Inventory Turnover;
- Inventory Aging; and,
- Customer Facing Trade Ratio.

Under the rule, a banking entity is required to report and calculate all applicable metrics for each trading day. The frequency of reporting varies depending on the banking entity's size. The largest banking entities with $50 billion in consolidated trading assets and liabilities must report on a monthly basis. All other banking entities are required to report on a quarterly basis. The reports, either monthly or quarterly, must be reported no later than 10 days after the end of the calendar. The effective dates for the quantitative measurements have been delayed until June 30, 2014 through April 30, 2016 depending on the banking entity's size. See effective date section below for specific details.

Effective Date

The final rules become effective on April 1, 2014. The conformance period has been extended until July 21, 2015. Beginning June 30, 2014, banking entities with $50 billion or more in consolidated trading assets and liabilities will be required to report quantitative measurements. Banking entities with at least $25 billion, but less than $50 billion, in consolidated trading assets and liabilities will become subject to this requirement on April 30, 2016. Those with at least $10 billion, but less than $25 billion, in consolidated trading assets and liabilities will become subject to the requirement on Dec. 31, 2016. The agencies will review the data collected prior to Sept. 30, 2015, and revise the collection requirement as appropriate.

What Steps Banking Entities Should Take to Ensure Compliance?

In anticipation of the approval of the final rules, many banking entities are in various stages of readiness based upon their "good faith" conformance period efforts. Regardless of the efforts to date, banking entities must now create and enact act plans to ensure compliance with the final rule and the metrics reporting and compliance plans. Some key components of an action plan include:

- Conduct or continue to conduct business analysis of impact on trading desks: identifying which products and trading desks are affected by the rule and quantifying trading assets and liabilities to identify compliance periods begin. Also, develop a plan to demonstrate how the activities of the trading desks are considered permissible investments. In addition, banking entities should review current investments and analyze whether the current investment is permissible or should the company divest the investment.

- Develop an approach / process for reporting: identify what information is needed to report the required seven quantitative measurements and develop a sustainable reporting process. This includes identifying business user requirements, identifying any system changes and the development of a budget and project plan.

- Develop / prepare the six components of an enhanced compliance program: the six components include a) written policies and procedures that establish trading and exposure limits, and are designed to ensure compliance, b) internal controls, c) management framework that defines compliance responsibility and accountability, d) independent testing and audit, e) training, and f) recordkeeping.

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