☎ 617.237.6111
✉info@databoiler.com
DataBoiler.com

Volcker independent testing: MCQ or long essay?

*By **Kelvin To**, Founder and President of Data Boiler Technologies*

Tests/exams are an inevitable part of learning. We have yet to find a better way to replace this imperfect method to assure a person/entity possess certain knowledge/capabilities. Same is true for Volcker. There haven't been clear mandates on how independent testing should be carried out, yet banks and regulators are relying on the test results to gauge the degree of effectiveness of banks' compliance programs. So, in considering the preferred format (MCQ or Long Essay) of the test, one should keep in mind the ultimate objective of any test/exam – i.e. validation of attaining mastery of the materials (correct usage of exemptions and prevent violations of proprietary trading/ covered fund requirements in context of Volcker compliance).

It is not hard to view the Volcker independent test as a "multiple-choice exam" because banks are given multiple exemptions (market making, underwriting, risk-mitigating hedges, liquidity management, etc.) for their trade activities. Trades that do not qualified for any exemptions are considered violations. Voila! An independent test is just that simple – one essential MCQ to verify trades being appropriately tagged with the right exempt category. If banks' Volcker compliance programs are effective, then the testing results should affirm the correctness of these exemptions. Ideally, all trades should go through a vulnerability scan, so banks can take this opportunity to clearly show to the regulators that they are inviolate. Hence, they don't have to worry about the "guilty until proven otherwise" provision of Volcker, and CEOs can comfortably sign-off on their attestations.

However, external auditors/ consultants probably won't be happy with this simple MCQ because it makes their long list of services seem so irrelevant to the two key primary objectives of the rule: (a) proprietary trading ban, and (b) restrain ownership of covered funds. From a positive note, they are doing their due-diligence to ensure bank's compliance program contains "all" of the required elements, such as documentations, training, and reports. They'll be happy to talk with banks on risk culture and conducts, risk appetite statement, broad ERM concepts and other governance theories. Don't get me wrong, these risk management best practices do offer tremendous value for banks. In fact, are management consultants recruited to teach bank managers how to 'manage', or are they really hired to solve specific problems?

This leads back to the three original questions of Volcker compliance: (1) how banks determine 'reasonableness' in securities inventory each day, (2) how banks distinguish trade intent when both permitted and prohibited trades may

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involve taking principal positions, and (3) how banks ensure financial stability and prevent rogue traders from bypassing the controls. As mention in this earlier article, these questions are solvable while the methods are not obvious. If the consulting communities aren't able to satisfactorily answer these three long and hard questions, their bank clients would naturally want to digress (see this related article).

Consider the independent testing as a "long and comprehensive (or cumbersome) checklist". The more questions it asks on the ancillary matters of Volcker, the more it detracts from the three original questions. Judgement will then be shifted to focus on how well someone can "articulate" their compliance program rather than its true effectiveness. There are price tags attached to ghost writers' or advisory firms' services, so how well you want to articulate depends on how much you are willing to pay. But that doesn't guarantee the passing of the test. Banks must avoid conflict of interest when retaining qualified party to conduct independent testing. They shouldn't be hiring the same party for both preparation work and the evaluation of related compliance. The reality though, as the pool of capital markets consultants and auditors are limited in supply, no one likes to burn bridges in a closed circle and accuse others, which may jeopardize his/her possible future career.

As a result, don't expect this "long" format of testing will reveal many faults to anyone's surprise year after year. Yet, I do feel sorry for those who need to deal with inessential questions from the so-called "qualified testers". These inessential questions may be moot points that depend on personal preference in articulation styles, and it won't pinpoint control weaknesses. In contrast, "MCQ approach" is able to detect which trades have violated what Volcker controls or how an exempt category may be incorrectly used. Responsible party(ies) may then trace back to the root of the problem and address them accordingly.

Be alert of false teachers who suggest banks to stuff trades into a particular exempt category for the convenience of it. It's like guessing all MCQ as "B" or "C". This may be considered as intentional tort that one should never attempt. After all, querying control breaches that are captured in a log-book is an "after-the-fact" investigation. Independent testing is no substitute to the Volcker requirement of having a "preventive system".

