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Volcker violation: felony or misdemeanor charges?

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Negligence means refusing to know or do better. If banks are still in denial believing that they have done nothing wrong and no further actions are needed to comply with Volcker, then I suggest they review my last 7 articles in the series (especially these two: enforceability and attestation). It only takes a quick scan for the examiners to identify proportion of incorrect usage of exemptions and/or slippages of proprietary trades through a bank's compliance/surveillance program. That percentage of inappropriateness is going to be weighted in by the prosecutors to gauge the degree of violations. Yet, there are additional factors in determining whether a case should be charged with felony or misdemeanor.

Since Volcker shifted the burden of proof to banks with the "guilty until proven otherwise" clause, prosecutors do not need to consider if available evidence will lead to a conviction by the "beyond-a-reasonable-doubt" standard. The probative facts from a vulnerability scan are sufficient to convince a prosecutor that the defendant is guilty. Although there may be no formal complaint from anyone regarding banks' inability to "totally" prevent or exterminate violations. Yet banks can be prosecuted from prejudicial standpoint that their committed wrongdoing are "tending to" impair others in a manner of conflicted interests. Current market sentiment is a head-wind against all banks.

It is understandable that defendants will use any possible circumstances to sway their case. Some may argue based on their "little or no history of engaging in proprietary trading". Some contend the process to register hedges at the inception and other requirements per § 5(b) cannot be followed, when traders were "under stress" of dynamic market moves. There could be other "mitigating" factors or circumstances that defendants miniaturize matters as lapses/oversights on rare-special occasions. However, closing a case without having the violator admit guilt or deny allegations is foreseen to be extremely hard under the Volcker regime. Remember the burden of proof has shifted to the defendants and negligence is an alleged act of committed wrongdoing when probative facts become accepted evidence in court. Moreover, falsified statement in CEO attestation can result in criminal charge.

Allow me to repeat what I've said in the first article of this series, "hammer hits the nail and the nail hits the wood". Politicians have waited long for this Volcker deadline and they'll be pushing the regulators if the Rule cannot yield their desire outcomes". So, don't aggravate to prepare for litigation fights, but learn the areas of scrutiny and fix the related controls accordingly. In my opinion, examiners and prosecutors will first go after the low-hanging fruits of "clear

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violations”. These include but not limited to: short sells or leverages for trades initiated from the treasury desk, the use of OTC derivatives or futures for underwriting, and selling credit default swap when trades were tagged as risk-mitigating hedges, etc. Repeat offenses or use of synthetic created trades to bypass control may constitute as “reckless” act that may result in affirmative actions. Banks can use simple rule-based system automations to exterminate these prop trade violations (see this related article).

Next, I assume regulators will check against items on the “black list”. These include: questionable hedge (e.g. buy CDS but no available long position to protect), trades tagged with incorrect exempt categories (e.g. bond swap shouldn’t be tagged with underwriting but possibly be permissible under market making), and anything that is significantly greater than RENTD/hedge exposure/average funding needs. Other areas that will prompt regulators’ interests include: infrequent trade instruments/venue, inconsistent time/order size, and other matters in the “detection engine”. Prosecutors are well-versed with defendants’ tactics to argue the “50 shades of grey” in these areas. Therefore, they probably won’t charge the acts as “reckless”, but still allege the case as “malpractice” or “breach of duty” based on pattern of related offenses. Again, it won’t be easy for prosecutors to drop a case from felony to dismissal or misdemeanor charges of “negligence”. An appropriate risk management control here is the use of a filtering mechanism that consists of a scoring model to discern permissible versus prohibited trade activities.

Last but not least, the use of synthetic created trades to bypass controls by rogue traders may be considered as “intentional/ willful” violations. Prosecutors may suggest the court to severely penalize such acts. It is not hard for the examiners to unveil abusive acts after-the-fact, while it is extremely difficult to “prevent” such incidents unless banks have a robust system to analyze irregular trade patterns and detect possible market manipulations in real-time. Machine learning is the way to cope with these slick rogue traders who may cause huge losses. Don’t fall victim to rogue traders’ evil-plots; avoid prosecution and regulatory fines by embracing the necessary preventive risk controls now!

Disclaimer

The opinions expressed in this article are the opinions of Kelvin and may not reflect the wishful thinking of someone else who believe they are in compliance when they aren’t. This article is for informational purposes only and not for the purpose of providing legal advice.

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