Volcker Rule independent testing
Key considerations for developing a robust independent testing plan
Introduction

While it would be fair to say that banking institutions subject to the Volcker Rule ("the Rule") have conducted varying degrees of independent testing with respect to the effectiveness of their Rule compliance program over the past 18 months (i.e., since the conformance period end date of July 21, 2015), not all institutions have given adequate consideration toward developing a formal and robust independent testing plan that demonstrates how their Qualified Independent Party ("QIP") would provide a program of assurance with respect to the banking institution’s compliance with the Rule. While we acknowledge that the Rule by itself does not have an explicit requirement to develop such a planning document; we do, however, believe that such a formal document is critical both from an internal and external (regulatory) perspective. In this report, we discuss certain key considerations that institutions may want to reflect on as they review and enhance their existing planning documentation specific to the Rule’s independent testing.

1 Objectives of independent testing

The requirement to perform independent testing is reflected in both the standard compliance program requirements pursuant to Subpart D (Compliance Program Requirement; Violations), and in Appendix B (Enhanced Minimum Standards for Programmatic Compliance) of the Rule. The Independent Testing section within Appendix B specifies that the banking entity must promptly take appropriate action to remedy any significant deficiencies or material weaknesses in its compliance program and to terminate any violations of Section 13 of the Bank Holding Company Act of 1956 ("BHC Act") or Appendix B. While the reference here to significant deficiencies or material weaknesses refers only to their remediation, the inclusion of this paragraph would imply that identifying significant deficiencies or material weaknesses is also an objective of the independent testing. Additionally, banking institutions should also consider specifying clearly if one of the objectives of independent testing is also to conclude on Rule’s compliance and internal controls over compliance as conducting testing and reporting exceptions is not the same as concluding on the adequacy of design and operating effectiveness of these matters. Finally, the independent testing plan should also clearly indicate objectives, if any, that are beyond the scope of the organization’s independent testing requirements.

2 Scope of independent testing

Understanding the intended scope of independent testing is important for planning the independent testing, and/or understanding any limitations to scope and any commensurate impact to the banking organization’s evaluation of the results of the independent testing. The scope of independent testing may vary and be influenced by both the banking organization and its interpretation of the Rule requirements.

As we know, the Rule applies to all banking entities consistent with the statutory definition of a “banking entity” under the BHC Act. Given the vast reach of the Rule, a banking institution should consider the following while defining and documenting the scope of its independent testing:

- The identification of banking entities and the activities within the enterprise’s banking entities that would be subject to the Rule and hence within the scope of its independent testing. There may be affiliate or subsidiary banking entities which are neither fully consolidated, and for which available information pertaining to activities and controls may be limited. Banking entities for which the availability of information is limited would still need to be identified. Further, the approach to addressing the limited availability of information should be documented in the independent testing plan. If the limited availability of information impedes the ability to plan and/or execute the independent testing required by the Rule, consideration should be given to the extent such limitation would also limit the ability to evaluate the results of the independent testing.

- With respect to performing the independent testing, the banking organization should determine whether the enterprise would be stratified into one or more auditable entities. For example, a Foreign Banking Organization ("FBO") may determine to perform independent testing at the global/enterprise operations level (i.e., one auditable entity), by regional operations such as US vs. non-US operations, or by distinct legal entities or level within the organizational hierarchy (i.e., two or more auditable entities). In the case of the latter determination, separate and additional testing may be conducted, and a separate delineation of findings should be considered for each of the auditable entities.

- The banking organization should also consider clearly documenting in its independent testing plan any entity or activities that are not within the scope of its independent testing.
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In order to satisfy the Rule’s independent testing requirements, banking institutions in these initial years have largely adopted an operating model using a mix of internal audit, compliance personnel, and external consultants to execute their testing. One key driver for such an operating model has been the lack of requisite skill-sets within one control function given the breadth and complexity of the Rule. While the Rule allows the banking institutions to have some options with respect to the execution of the independent testing, there are constraints, considerations and trade-offs.

- Compliance professionals may have greater familiarity with the Volcker Rule requirements, however, internal audit generally has more experience in testing (including planning, scoping, and evaluating) and are equipped with more mature auditing tools, sampling methodologies, and work paper standards.

- Internal audit may be more readily ‘independent’ as they are not executing 2nd line of defense activities, and were not involved in the design of the compliance program.

- Constraints within both functions may suggest shared responsibility, but joint coordination has proven to be more challenging in practice than in theory. Furthermore, the issue remains as to which function or individual would be responsible for concluding on the overall results of the independent testing.

As organizations look to develop more sustainable and integrated testing plans, consideration should be given to the longer term strategy for executing this testing.

Adherence to testing standards
An interesting question arises as to which testing standard, if any, should be adhered to or considered in conducting the independent testing. In practice, the independent testing that is performed by internal audit departments is generally conducted pursuant to Internal Auditing Standards, while independent testing, wherein the compliance function serves as the QIP, is generally not performed pursuant to any formally promulgated testing standard.

The Rule itself does not specify standards for conducting the independent testing. However, the requirements to evaluate ‘the overall adequacy and effectiveness of the banking entity’s compliance program’, ‘the effectiveness of the banking entity’s internal controls’, and to identify significant deficiencies and material weaknesses, suggest analogy to auditing standards promulgated by the Public Company Accounting Oversight Board (PCAOB). This analogy is strengthened further if one believes that the objective of independent testing is to issue a report that contains an express conclusion regarding the effectiveness of compliance and internal controls over compliance.

On the one hand, applying PCAOB auditing standards that might be judged relevant represents a very high bar. The PCAOB auditing standards generally pertain to an audit of internal control over financial reporting (ICFR) that is integrated with an audit of financial statements. Consequently, assessing the relevance of these standards and applying them to an evaluation of the Rule’s compliance and internal controls over compliance requires significant judgment. Furthermore, applying these standards may result in meaningfully increased testing effort and time. On the other hand, the PCAOB standards establish requirements including for, among other testing activities, planning, controls testing, evaluating identified deficiencies, forming an opinion on internal controls, and reporting, that would certainly appear to be relevant to the objectives of independent testing. In this regard, and in recognition of their relevance, some institutions consider (but do not obligate themselves to adhere to) the PCAOB standards in conducting their
independent testing. As a result, their testing and reporting may be considered more robust.

Regardless of which approach a banking institution takes with respect to conducting its independent testing (i.e., adherence/consideration to a testing standard or not), it should make sure that such an intent is clearly documented in its independent testing planning document.

5 Testing approach

A key component of any independent testing plan is detailing the approach that a banking institution would adopt to test compliance and internal controls over compliance (‘ICOC’). Accordingly, while defining its testing approach an institution may want to consider and incorporate the following key components in its testing plan:

Testing phases: The planning document should highlight how the QIP plans to organize and execute the independent testing effort. Typically, testing is organized around three general phases of planning, fieldwork and reporting and should be executed in respect of each of the auditable entities.

Employing a sampling approach to testing: The Rule is silent on the issue of applying a sampling approach to testing. However, and as sampling is a widely accepted approach to testing, applying risk-based sample selection to testing has been employed by most institutions. A risk-based testing approach may be applied through establishing separate populations for each auditable entity. Furthermore, sampling could be undertaken across the three discrete testing dimensions that align with the provisions of the Rule:

- Banking entities – Controlled subsidiaries (consolidated and non-consolidated), affiliates, joint ventures, and other legal entities
- Proprietary trading – permitted proprietary trading activities, excluded and out-of-scope activities
- Covered funds – permitted covered fund activities and investments, excluded and out-of-scope funds

Testing procedures: The Rule and the Preamble identify specific testing procedures that should be performed for activities that rely on certain exemptions. Beyond the broad requirements for independent testing, and the testing required for certain exemptions, the Rule does not specify any additional testing procedures to be performed. The only further guidance to date would be the Volcker Rule Interim Examination Procedures (the “OCC Examination Guidance”) published in June 2014 by the Office of the Comptroller of the Currency (“OCC”). While we believe that an institution’s testing procedures could be informed by the OCC Examination Guidance, it should be noted that this Examination Guidance was issued as interim and intended to be augmented or superseded by subsequent guidance, and was for use by OCC examiners in assessing plans that banks developed and were implementing to comply with the regulation. Accordingly, this guidance is not itself sufficient to rely upon for developing the independent testing procedures. In particular, the Examination Guidance has good guidance related to ‘inventory and identification’ of activities, but is by design less useful for developing ‘assessment’ and ‘compliance’ testing procedures.

Evaluating the design of controls: Evaluating the design of controls requires significant experience and involves the greatest degree of judgement. Firstly, the Rule itself is subject to significant interpretation and prospective clarification from the US Agencies (the “agencies”). The QIP has an obligation to evaluate whether the institution’s interpretation of the Rule requirements is reasonable. This does not mean that every issue of interpretation needs to be re-opened. It does mean that the QIP should understand the process the institution employed to conclude that its interpretation were reasonable. For example, has the banking organization maintained a log of significant interpretations? Furthermore, was legal counsel consulted on these interpretations, and is counsel’s conclusion, as well as the facts upon which each conclusion is based, appropriately documented? Secondly,
the type and level of control necessary to reasonably assure that the control objectives are achieved is also a matter of significant judgment. This is particularly true in the implementation of significant and new regulation, as the financial services industry learned in complying with Sarbanes Oxley (“SOX”), Anti-money Laundering (“AML”), Fair Value Accounting, and other provisions of Dodd-Frank. On the one hand, an institution might be inclined to tolerate issues related to design effectiveness in the early period of implementation – especially in light of pending agency clarification and a relative lack of consensus regarding leading practices. On the other hand, many institutions suffered reputational embarrassment complying with all of the aforementioned regulations, and have also learned that doing it right in the beginning can be less costly than fixing it on an ex-post basis.

**Materiality:** The concept of materiality is an important consideration in performing and evaluating testing. Applying the concept of materiality to testing generally has been considered by some to be both controversial and complex. This is no less so for independent testing, however the daily operating cycle and greater granularity required to comply with the Rule significantly increases the requirement for measurement quality and accuracy specifically with respect to the quantitative measures, thresholds, and limits (collectively “Quantitative Measures”). Given the magnitude of this challenge, the QIP may be inclined to tolerate a greater error rate or inaccuracy. However, applying materiality thresholds that are too high, and/or which rely on rule of thumb (e.g., 5%) and do not consider context may, in the near term, impede an institution from identifying findings necessary to improving the quality and accuracy of their quantitative measures to acceptable levels and, in the longer term, may subject the QIP to criticism and the institution to unacceptable compliance risk.

**Reliance on other internal controls:** In order to execute an efficient and effective evaluation, institutions should consider relying, if appropriate, on certain entity and transaction level controls and, as such, document this as part of their independent testing plan. Examples of such controls may include:

- Internal controls over financial reporting. ICFR refer to an entity’s internal controls that have been designed and implemented to provide reasonable assurance that external financial reporting is not materially misstated. While many of the Rule’s compliance controls will be distinct from ICFR, a banking entity’s Volcker Rule compliance is generally supported by ICFR. For example, the daily P&L attribution is dependent on effective valuation and independent price verification (“IPV”) controls. ICFR are generally subject to SOX testing, and thus may potentially be relied upon. However, if there are identified deficiencies in ICFR, the deficiencies should be evaluated to determine the Rule impact, if any.

- Information technology general controls (“ITGC”). If applications and data stores supporting Volcker Rule compliance are subject to an institution’s ITGC (e.g., security, change management, etc.), it may be reasonable to rely upon them. Alternatively, if Volcker Rule compliance is supported by end user developed applications (“EUDAs”) such as spreadsheets outside of an institution’s ITGC, the controls of these applications and data stores may need to be separately evaluated and tested.

- Model review controls (“MRC”). MRC support quantitative measurement and their required reporting. These measurements and their controls are subject to independent testing, however, it may be appropriate to rely on MRC if the Rule’s measurement methodologies have been subject to MRC, unless there is a determination that there are control deficiencies that would preclude such reliance.

**Evaluating the results of independent testing**

The objective of independent testing includes, among other requirements:

- Analysis and documentation of instances in which such internal controls have been breached, and how such breaches were addressed and resolved.
- Identifying significant deficiencies or material weaknesses.

However, the Rule in itself does not contain any definition of a breach, significant deficiency, or material weakness, and does not provide any guidance for how to conduct an evaluation of these items. Accordingly, the definition as to what would constitute a breach, significant deficiency or a material weakness would be the responsibility of the board of directors or the QIP and these
definitions should be clearly documented in the independent testing plan.

**Evaluating breaches**: While varying definitions of a breach could be utilized, a breach may be defined as the failure to adhere to a control that has been implemented, or the failure to implement a control that was mandated through policy by the company itself. This definition may include the failure to evidence, as appropriate, adherence to a control that has been implemented, or was mandated to be implemented. The determination, however, as to the appropriate level for evidencing the performance of a control could vary based upon the nature of the control, and would accordingly still be a matter of judgment.

**Evaluating significant deficiencies/ material weaknesses**: The determination as to whether deficiencies exist may be based on judgment regarding the reasonableness of design or operating effectiveness necessary to achieve the control objective. However, if the testing has identified one or more deficiencies in internal control over compliance, each deficiency should be evaluated to determine whether, individually or in combination, they constitute a significant deficiency or material weakness. In this regard, the banking entity may want to consider the following in their plan:

- The determination as to whether a deficiency(ies) is significant or constitutes a material weakness, should be based on the severity of the potential non-compliance or violation that could result. This determination is a matter of professional judgment, and may require consultation with legal counsel.
- The QIP may evaluate the severity of a deficiency by considering whether there is a reasonable possibility that the company’s controls over Volcker Rule compliance would fail to prevent or detect non-compliance, and the severity of the potential non-compliance that might result.
- The severity of a deficiency may not depend on whether a violation or non-compliance has actually occurred, but rather on whether there is a reasonable possibility that the company’s controls would have failed to prevent or detect a violation or non-compliance.

**7 Reporting independent testing results**

The independent testing plan should document to whom (i.e., list of stakeholders who would receive interim reporting) and at what frequency (e.g., after the completion of each phase of testing) the QIP would communicate and escalate identified independent testing issues or control deficiencies to permit senior management to prioritize and remediate accordingly. It should also include how the QIP would monitor the progress and resolution of findings in accordance with its methodology and mandate. Finally, it should clarify when a final independent testing report would be issued (this is typically issued subsequent to the completion of fieldwork and post fieldwork review procedures) and if this final report would provide a conclusion on the overall adequacy and effectiveness of the compliance program as well as on the other independent testing objectives required by the Rule.

**8 Limitations of the effectiveness of independent testing**

Banking entities should recognize that there are limitations to the effectiveness of the independent testing of Volcker Rule compliance and internal controls over compliance and that these should be acknowledged within their independent testing planning document. Limitations that banking organizations may want to consider as part of their independent testing program could include, but are not limited to, the following:

- Independent testing necessarily involves judgment. For example:
  - There is use of judgment in sampling as testing employs sampling techniques rather than undertaking complete testing of the entire population.
  - There is judgment in determining the reasonableness of controls to achieve Volcker Rule compliance, particularly in the absence of established industry experience and leading practices.
  - Evaluating compliance with the Rule involves interpretive judgment due to lack of clear instructions related to independent testing as well as varying interpretations of the Rule’s compliance requirements related to certain provisions (which require further agency clarification).
- The subsequent discovery that material non-compliance exists would not, in and of itself, evidence inadequate planning, performance, or judgment in relation to the independent testing.
- There may be practical and / or legal limitations to obtaining sufficient and appropriate evidence.

While it is imperative for banking

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organizations to understand and acknowledge the limitations with respect to the effectiveness of independent testing, they should further recognize the fact that independent testing may not always necessarily reveal non-compliance, significant deficiencies, or material weaknesses in their internal controls. The objective of independent testing approach and procedures are to obtain reasonable but not necessarily absolute assurance regarding compliance and the design and effectiveness of internal controls over compliance.

**Relationship of the CEO review and attestation/sub-attestations to independent testing**

Banking entities subject to the Enhanced Compliance Program requirements (i.e., Appendix B) of the Rule are also required to provide an annual CEO attestation. The CEO attestation has resulted in increased importance and focus by institutions on their independent testing program and is clearly seen as an important pillar upon which the CEO attestation is based. However, while the results of the independent testing may inform the CEO of any identified non-compliance, material weaknesses or significant deficiencies in the banking entity’s compliance program, the institutions’ independent testing planning document should clearly note that these results are not by themselves sufficient to form the entire basis of the CEO attestation. Accordingly, in addition to independent testing results, the CEO review may include, but not be limited to, the following additional elements for consideration:

- **Sub-attestation:** Representations or sub-attestations by individuals within the banking entity that have primary or oversight responsibilities for the banking entity’s compliance with the Rule.
- **Violations:** Knowledge of potential compliance violations, regulatory examination findings, material weaknesses, or significant deficiencies that are derived from sources or activities which are distinct from independent testing.
- **Entity level controls:** Judgments regarding entity level controls which are outside the scope of independent testing, but which are critical for compliance.
- **Limitations of testing:** Other limitations in the scope of independent testing, which may be evaluated or addressed through other means.
- **Third-party feedback:** Information, opinions, or representations by third parties, including but not limited to outside attorneys, and third-party service providers.

In addition, the scope of independent testing should include an evaluation by the QIP of the effectiveness of, and responses to, the banking entities Volcker Rule sub-attestation process. While there is significant diversity of practice, institutions have generally implemented such a program of sub-attestation for Volcker Rule compliance and internal controls over compliance. A reference regarding the robustness of the Rule’s sub-attestation process may be the institution’s similar or parallel processes for SOX and ICFR. One evaluation objective would be to determine whether the scope of the sub-attestation is comprehensive and complete. Lastly, and in addition, the QIP should satisfy itself that exceptions and qualifications which arise pursuant to this process are reviewed, resolved and concluded upon, and whether such qualifications or exceptions impact the results of independent testing.

**Recordkeeping and retention of testing program documentation**

As per the Rule’s recordkeeping requirement, banking entities must create and retain records sufficient to demonstrate compliance and support the operations and effectiveness of the compliance program. Accordingly, the independent testing documentation including the independent testing plan, test procedures, sample selection documentation, testing work papers including memoranda documenting conclusions, reporting, and other documentation would be all subject to these requirements and should be retained for no less than five years (or such longer period as required by the agencies) in a form that would allow them to be promptly produced upon a regulator’s request. An institution’s independent testing plan should address this retention requirement as well as document the recordkeeping location with respect to the testing program work papers and related documentation.
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1. International Standards for the Professional Practice of Internal Auditing (Standards), issued October 2008 Revised October 2012 by the Institute of internal Auditors.
2. https://pcaobus.org/Standards/Auditing/Pages/default.aspx
3. The U.S. Volcker Agencies include: the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission.
5. http://www.finra.org/industry/aml

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