

TO: Board of Governors

DATE: December 9, 2013

FROM: Staff¹

SUBJECT: Draft final rule implementing the proprietary trading and hedge fund and private equity fund prohibitions and restrictions of section 13 of the Bank Holding Company Act

ACTION REQUESTED: Staff seeks Board approval of: (1) the attached draft final rule (Attachment A, pp. 1-71) and draft Federal Register notice (Attachment B, pp. 72-962), implementing the so-called “Volcker Rule” requirements of section 13 of the Bank Holding Company Act (“BHC Act”), which were added by section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”),² and (2) the attached Order (Attachment D, pp. 975-978) extending the conformance period under section 13 of the BHC Act for all banking entities until July 21, 2015. Section 13 generally prohibits two activities of banking entities: (i) engaging in proprietary trading; and (ii) owning, sponsoring, or having certain relationships with a hedge fund or private equity fund. The final rule has been developed jointly with the Office of the Comptroller of the Currency (“OCC”), the Federal Deposit Insurance Corporation (“FDIC”), the Securities and Exchange Commission (“SEC”), and the Commodity Futures Trading Commission (“CFTC”) (together, “the Agencies”). Staff also requests authority to make conforming changes (for example, to incorporate approved changes requested by the other Agencies as part of the approval process) as well as minor technical changes (for example, to conform to Federal Register requests and correct non-

¹ Messrs. Alvarez and Paridon, and Ms. Harrington (Legal Division); Mr. Van Der Weide (Division of Banking Supervision and Regulation); and Mr. Campbell (Division of Research and Statistics).

² Pub. L. No. 111-203; see Dodd-Frank Act § 619; 12 U.S.C. 1851. A copy of section 13 of the BHC Act is attached as Attachment C, pp. 963-974.

substantive errors in the documents) to the attached draft final rule and draft Federal Register notice.

EXECUTIVE SUMMARY: To implement the requirements of section 13 of the BHC Act, the final rule would:

- Prohibit any banking entity from engaging in proprietary trading. Under the statute, proprietary trading involves acquiring or taking positions as principal in any security, derivative, option or contract for sale of a commodity for future delivery for the purposes of selling the security or position in the near term or otherwise with the intent to resell to profit from short-term price movements. This prohibition is subject to exemptions for underwriting, market making-related activities, risk mitigating hedging, activities of foreign banking entities solely outside the U.S., and certain other activities;
- Require firms with significant trading operations to report to the relevant Agency a number of quantitative measurements that are designed to assist the Agencies and banking entities in identifying prohibited proprietary trading that might occur in the context of exempt activities;
- Prohibit any banking entity from acquiring or retaining an ownership interest in, or having certain relationships with, a hedge fund or private equity fund (“covered fund”), subject to exemptions for investments made in connection with organizing and offering a covered fund, making and retaining *de minimis* investments in a covered fund, activities of foreign banking entities solely outside the U.S., and certain other activities; and
- Require banking entities to establish an internal compliance program designed to help ensure and monitor compliance with the prohibitions and restrictions of the statute and the final rule.

The draft final rule includes a number of elements intended to reduce the burden of the final rule on smaller, less-complex banking entities by limiting the requirements of various compliance program and reporting requirements on these banking entities. For example, the draft final rule limits the scope of banking entities that are required to report quantitative measurements to those with

significant trading activities. The draft final rule also allows smaller banking entities to implement simpler compliance programs and does not impose a compliance program requirement on banking entities that do not engage in activities or investments (other than trading in government obligations) covered by section 13 and the final rule.

DISCUSSION: Section 13 of the BHC Act generally prohibits any “banking entity” from engaging in proprietary trading and acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a covered fund, subject to certain exemptions.³ The term “banking entity” includes: (i) any insured depository institution; (ii) any company that controls an insured depository institution (including a bank holding company (“BHC”) and savings and loan holding company (“SLHC”), or any other company that controls an insured depository institution but that is not a BHC or SLHC, such as the parent company of an industrial loan company); (iii) any foreign bank that is treated as a bank holding company for purposes of section 8(a) of the International Banking Act of 1978 (e.g., any foreign bank operating a branch or agency in the U.S.); and (iv) any affiliate or subsidiary of any of the foregoing (e.g., a broker-dealer subsidiary of a BHC).

³ See 12 U.S.C. § 1851(a)(1). Section 13 of the BHC Act also provides that nonbank financial companies designated by the Financial Stability Oversight Council (“Council”) that engage in proprietary trading activities or make investments in covered funds may be made subject by the appropriate Agency or Agencies to additional capital requirements or quantitative limits although such companies are not subject to the prohibitions in section 13 that apply to banking entities generally. See id. at §§ 1851(a)(2) and (f)(4). Two of the three firms that have been designated by the Council currently control an insured depository institution, and are, therefore, banking entities subject to the final rules. Staff is exploring whether the third entity engages in any activity that would be subject to section 13 of the BHC Act, and will propose action consistent with that section if appropriate and applicable.

Authority for developing and adopting regulations to implement section 13 of the BHC Act is divided among the Board, OCC, FDIC, SEC, and CFTC.⁴ Section 13 of the BHC Act became effective on July 21, 2012.⁵

In October 2011, the Board, OCC, FDIC and SEC sought public comment on a proposed regulation implementing the provisions of section 13 of the BHC Act.⁶ The period for filing public comments on this proposal was extended until February 13, 2012. On January 11, 2012, the CFTC requested comment on a substantially similar proposed rule and invited public comment through April 16, 2012.⁷

The Agencies received over 18,000 comments addressing a wide variety of aspects of the proposal, including regarding the definitions in the proposal, the scope of the exemptions for market making-related activities and risk-mitigating hedging activities, the limits on covered fund activities and investments, the use of metrics, and the compliance and reporting burden. The vast majority of these comments were from individuals using a version of a short form letter to express

⁴ See 12 U.S.C. § 1851(b)(2). Under section 13(b)(2)(B) of the BHC Act, rules implementing section 13 with respect to insured depository institutions must be issued jointly by the Board, the OCC, and the FDIC. The Board is granted authority to issue implementing rules with respect to any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act, any nonbank financial company designated by the Council, and any subsidiary of any of the foregoing (other than a subsidiary supervised by the OCC, FDIC, SEC or CFTC). The SEC and CFTC, respectively, issue rules with respect to any entity for which it is the primary financial regulatory agency. See id. The Secretary of the Treasury is responsible for coordinating the Agencies' rulemakings under section 13 of the BHC Act. See id. at § 1851(b)(2)(B)(ii).

⁵ See 12 U.S.C. § 1851(c)(1).

⁶ See 76 FR 68,846 (Nov. 7, 2011).

⁷ See 77 FR 8332 (Feb 14, 2012).

support for the proposal. Nearly 500 comment letters were substantive and unique comment letters from the public, including from members of Congress, domestic and foreign banking entities and other financial services firms, trade groups representing banking, insurance, and the broader financial services industry, U.S. state and foreign governments, consumer and public interest groups, and individuals. The staffs of the Agencies met with a number of these commenters to understand issues relating to the proposal, and summaries of these meetings are available on the Agencies' public websites.⁸

While many commenters generally expressed support for the broader goals of the proposal, a number of commenters criticized specific aspects of the proposal or suggested modifications to various sections of the proposal. Many commenters expressed concerns about the potential costs and burdens of various aspects of the proposal, particularly for smaller, less-complex banking entities. Some commenters also requested additional time to develop and implement compliance programs and to conform their activities and investments to the requirements of section 13. Staff has reviewed the comments received in response to the proposal and worked with the staffs of the other Agencies to modify the proposal to address commenter concerns in a manner consistent with the statute and its purposes.⁹

A. Prohibition on Proprietary Trading

The prohibition in section 13 on engaging in proprietary trading covers “engaging as principal for the trading account of the banking entity in any transaction to purchase, sell, or otherwise acquire or dispose of” any security, derivative, or commodity future, or other financial instrument determined by rule

⁸ See, e.g., http://www.federalreserve.gov/newsevents/reform_systemic.htm.

⁹ A summary of the comments may be found in the Secretary's Office.

to be covered.¹⁰ The statute covers only positions held in a “trading account.” The statute defines “trading account” as any account used to hold a financial instrument “principally for the purpose of selling in the near-term (or otherwise with an intent to resell in order to profit from short-term price movements).”¹¹

Similar to the statutory definition, the final rule defines “trading account” as any account that is used to take positions principally for the purpose of short-term resale, benefitting from short-term price movements, locking in short-term arbitrage profits, or hedging another trading account position.¹² Under the final rule, this would include any account that holds a financial instrument that is both a covered position and a trading position (or a related hedge) under the market risk capital rules, if the banking entity is an insured depository institution, BHC, or SLHC subject to those rules. Trading account also includes any account of a registered securities dealer, swaps dealer or security-based swaps dealer in the U.S. or entity that engages in the business of such a dealer outside of the U.S. For additional clarity, the final rule includes a presumption that a position held for fewer than 60 days is considered to be held in a trading account, unless the banking entity can demonstrate that the position was not acquired principally for short-term trading purposes.¹³

As in the statute, under the final rule only positions taken by a banking entity as principal are covered by the statute and final rule. Moreover, the statute and

¹⁰ See 12 U.S.C. § 1851(h)(4).

¹¹ See *id.* at § 1851(h)(6).

¹² See final rule § __.3(b) (p. 6 of Attachment A). The final rule also includes within the definition of trading account all positions held by securities and derivatives dealers in connection with their dealing activities. See final rule § __.3(b)(1)(iii); Attachment B (pp. 31-44 of Attachment B).

¹³ See final rule § __.3(b)(2) (p. 7 of Attachment A); Attachment B (pp. 44-48 of Attachment B).

final rule cover only positions held with short-term intent. Accordingly, and consistent with the language and purpose of section 13, the final rule does not include within the prohibition on proprietary trading activity such as clearing, liquidity management, transactions in satisfaction of debts previously contracted, or other types of transactions that do not involve an intent by the banking entity to resell in order to profit from short-term price movements.¹⁴ However, in order to limit the potential misuse of these exclusions through the mischaracterization of proprietary trading activity, the final rule imposes a number of limits and requirements on these exclusions that are designed to ensure that a banking entity does not engage in prohibited proprietary trading through these types of activities.

The final rule uses the term “financial instrument” to describe the types of instruments subject to the proprietary trading prohibition. Consistent with the statute, a “financial instrument” includes any security, commodity forward, or derivative, but does not include loans, spot commodities or spot foreign exchange or currency. The term “derivative” is defined for these purposes to include a wide variety of derivative transactions and instruments, including foreign exchange swaps and forwards, making these instruments subject to the prohibition on proprietary trading.¹⁵

Exempt trading activities.

The statute provides exemptions from the prohibition on proprietary trading for a number of trading activities, including exemptions for:

- Trading in U.S., State, municipal and government sponsored entity (“GSE”) obligations;

¹⁴ See final rule § __.3(d) (pp. 7-9 of Attachment A); Attachment B (pp. 55-80 of Attachment B).

¹⁵ See final rule § __.2(h) (pp. 3-4 of Attachment A); Attachment B (pp. 48-55 of Attachment B).

- Underwriting and market making-related activities that are designed not to exceed the reasonably expected near term demands of clients, customers, and counterparties;
- Risk-mitigating hedging activities of the banking entity;
- Transactions on behalf of customers;
- Trading for the general account of a registered insurance company; and
- Trading by a foreign banking entity solely outside of the United States.¹⁶

In addition to these statutory exemptions, section 13(d)(1)(J) permits the Agencies to exempt, by rule, any other activity the Agencies determine promotes and protects the safety and soundness of banking entities and the financial stability of the United States.¹⁷

1. Market-making related activities. Consistent with the statute, the final rule exempts market making-related activities from the prohibitions on proprietary trading. The final rule includes a number of requirements designed to ensure that exempt market making-related activity is genuinely client-facing and designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties.¹⁸ This aspect of the final rule requires that any banking entity relying on the market-making exemption:

- Routinely stand ready to purchase and sell one or more types of financial instruments for its own account in commercially reasonable amounts and throughout market cycles taking account of the liquidity, maturity and depth of the market for the relevant financial instruments;

¹⁶ See 12 U.S.C. § 1851(d)(1).

¹⁷ See *id.* at § 1851(d)(1)(J).

¹⁸ See final rule § __.4(b) (pp. 13-15 of Attachment A); Attachment B (pp. 140-317 of Attachment B).

- Ensure that the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, based on the liquidity, maturity, and depth of market and demonstrable analysis of historical and projected customer demand (exclusive of trading with other large market-making competitors);
- Establish and comply with written policies and procedures that include:
 - A description of the financial instruments the trading desk makes a market in;
 - The actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure;
 - Limits for each desk on its market-maker inventory, financial exposures, allowable risks, and market-making hedging activities;
 - Authorization and escalation procedures for trading activity that would exceed the trading desk's limits; and
 - Appropriate internal controls and monitoring of compliance with limits by each trading desk;
- Compensate the relevant employees in a way that does not reward or incentivize prohibited proprietary trading; and
- Be appropriately registered as a dealer under relevant securities or commodities laws.¹⁹

Many commenters objected to the proposed requirement that market-making activities be designed to generate revenues primarily from fees or other customer revenues. Commenters also requested that the final rule more clearly permit market making-related activities in different asset classes and under a variety of market conditions. After considering these comments, the final rule does not require that market making-related activities be designed to generate revenues primarily from fees or other customer revenues; however, the final rule requires

¹⁹ See id.

banking entities with significant trading activities to report data regarding patterns of revenue generation by market-making trading desks involved in market-making activities that may warrant further review of the desk's activities and may be informative over time about whether a market maker's activities are designed to facilitate and provide customer intermediation. Additionally, the final rule more clearly indicates that a banking entity may engage in market-making in different types of asset classes and that market making-related activity may vary based on the liquidity, maturity, and depth of the market for the particular financial instrument.²⁰

The final rule makes clear that dealers in securities, derivatives, and other financial instruments may continue to act as principal when making markets. The preamble to the final rule also explains that the market-making exemption (and in some cases the statutory exemption for underwriting activities explained below) permits banking entities to engage in primary dealer activities, act as an authorized participant for exchange traded funds, and act as a block positioner, in each case to the extent otherwise permitted under applicable law and in accordance with the framework governing market making-related (or underwriting, as relevant) activities contained in the final rule. The final rule does not mandate a shift to an agency model whereby dealers could act only in the capacity of broker or agent, nor does it prescribe standardized regulatory limits on the amount of inventory or principal risk that a market maker may retain (though, as noted above, the rule requires the banking entity to establish and enforce these types of limits).

2. Underwriting activities. As provided in the statute, the final rule exempts securities underwriting activities. As with market making-related activities, the underwriting exemption is subject to a number of requirements

²⁰ See final rule § __.4(b)(2)(i) (pp. 13-14 of Attachment A); Attachment B (pp. 155-157, 186-187 of Attachment B).

designed to ensure that exempt underwriting activity is genuinely client-facing and designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties.²¹ For example, the final rule limits the underwriting exemption to the distribution of securities; requires a compliance program with limits on inventory, exposures and the period of time a security may be held; and requires the banking entity to dispose of its underwriting position within a reasonable period.

3. Risk-mitigating hedging activity. The final rule incorporates the statutory exemption for risk-mitigating hedging activity, subject to a number of requirements designed to ensure that the exemption permits only hedging that is risk-mitigating and related to identifiable financial positions of the banking entity. These limitations include requirements that any permitted hedging activity, at the inception of the hedge, be designed to reduce or otherwise significantly mitigate and demonstrably reduce or otherwise significantly mitigate one or more specific, identifiable risks to the banking entity in connection with and related to positions, contracts or other holdings of the banking entity. Additionally, the hedging activity may not give rise, at the inception of the hedge, to any significant new or additional risk that is not itself hedged contemporaneously in accordance with the hedging exemption, and hedging activity must be monitored and managed over time.²² The final rule also requires that the banking entity compensate employees engaged in hedging activity in a way that does not reward or incentivize prohibited proprietary trading.

²¹ See final rule § __.4(a) (pp. 11-13 of Attachment A); Attachment B (pp. 80-140 of Attachment B).

²² See final rule § __.5 (pp. 16-18 of Attachment A); Attachment B (pp. 317-362 of Attachment B).

Consistent with the statute, the final rule permits risk-mitigating hedging of both individual and aggregated positions, contracts or other holdings of the banking entity. However, to prevent abuse of this statutory exemption, the final rule requires that the hedging be related to identified positions, contracts and other holdings of the banking entity. The preamble explains that these requirements are designed to prevent the risk-mitigating hedging exemption from being used to engage in scenario hedging, revenue hedging, general asset-liability management or other activities not related to individual or aggregated positions, contracts or other holdings of the banking entity.

The final rule has been strengthened from the proposal in several aspects to prevent banking entities from conducting prohibited proprietary trading under the guise of hedging. Specifically, the final rule requires that hedging be conducted in compliance with a written program that documents authorized hedging instruments, positions, limits, strategies, and techniques that may be used for hedging, and that includes internal controls and ongoing monitoring and authorization procedures, including independent testing of limits and escalation procedures to exceed or change limits.

Importantly, the final rule requires a banking entity relying on this exemption to conduct analysis and independent testing to ensure that hedging positions, techniques, and strategies may reasonably be expected to demonstrably reduce or significantly mitigate risk being hedged. This analysis must include an analysis of the correlation of the hedging activity with the positions being hedged. The final rule also contains a requirement that a banking entity document hedging activity that is conducted by a unit of the banking entity other than the trading desk responsible for the position, contract, or other holding being hedged, and also document any hedging done by a trading desk using a technique, strategy or

instrument that is not identified in the written hedging policy governing that trading desk.

These limits and requirements are designed to prevent the type of activity conducted by banking entities in the past that involved taking large positions using novel strategies to attempt to profit from potential effects of general economic or market developments and thereby potentially offset the general effects of those events on the revenues or profits of the banking entity. The documentation requirements in the final rule support these limits by identifying activity that occurs in reliance on the risk-mitigating hedging exemption at an organizational level or desk that is not responsible for establishing the risk or positions being hedged.

4. Permitted liquidity management. The final rule permits trading for purposes of liquidity management. This activity is not prohibited by the statute because the purpose of the activity is ensuring that the banking entity can meet its obligations as they come due, and the activity is not “for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements),” which defines the trading activity prohibited by the statute.

To ensure that liquidity management is not proprietary trading in disguise, the final rule requires that:

- Liquidity management be conducted in accordance with a written liquidity management plan that identifies the securities that may be used for liquidity management, the circumstances in which they may be used, and the amount, types and risks of these securities that are consistent with liquidity management;
- The securities be purchased and sold for the purpose of liquidity management and not for the purpose of short-term resale or benefitting from short-term price movements;

- The securities be highly liquid and limited to securities that are not expected to give rise to appreciable profits or losses in the short-term;
- The amounts held are consistent with the near-term funding needs of the banking entity;
- There be independent testing, internal controls and analysis that ensure that the securities are held for liquidity management purposes; and
- The liquidity management plan and activities be consistent with the requirements of the primary Federal supervisor for the banking entity.²³

5. Insurance companies. The statute exempts trading by a regulated insurance company or an affiliate for the general account of the insurance company. The final rule also exempts trading by an insurance company through a separate account. Trading in a separate account under the insurance laws represents trading on behalf of customers, an activity exempt under the statute. A separate account maintained by an insurance company is an account in which all the assets are legally segregated from the insurance company's other assets and all the income, profits and losses from those assets accrue to the separate account without regard to the profits, losses or assets of the insurance company. Under the final rule this exemption applies only to activity for a regulated insurance company and requires that the insurance company conduct the activity and maintain the accounts in accordance with applicable state insurance laws.²⁴

6. Trading by foreign banking entities. As provided in the statute, the final rule permits foreign banking organizations to engage in proprietary trading

²³ See final rule § __.3(d)(3) (p. 8 of Attachment A); Attachment B (pp. 60-66 of Attachment B).

²⁴ See final rule § __.6(d) (pp. 19-20 of Attachment A); Attachment B (pp. 400-408 of Attachment B).

“solely outside of the United States” (the “SOTUS exemption”).²⁵ A number of commenters objected to the transaction-based approach to this exemption taken in the proposal as too restrictive, arguing it would cut off U.S. financial markets from foreign capital and result in U.S. financial markets moving offshore.

In response, the final rule adopts a risk-based, rather than transaction-based, approach that permits a foreign banking entity to rely on the exemption only if:

- The foreign banking entity acts as principal in the purchase or sale outside the United States;
- The banking entity (including relevant personnel) that makes the decision to purchase or sell is not located in the United States;
- The purchase or sale, including any related hedging transactions, is not accounted for as principal in the United States;
- No financing for the banking entity’s purchase or sale is provided by a U.S. affiliate of the foreign banking entity; and
- The purchase or sale is not conducted with or through any U.S. entity, other than on an anonymous basis on a U.S. exchange or through an unaffiliated intermediary in a transaction cleared through a U.S. central counterparty, or in a transaction with the foreign operations of a U.S. entity.²⁶

This risk-based approach is consistent with the exemption in the statute for proprietary trading solely outside of the United States, which focuses on trading as principal (the risk of the trade) where the purpose is to benefit from short-term price movements (the purpose and decision-making for the trade). Allowing foreign banking entities to conduct proprietary trades on U.S. exchanges and

²⁵ See final rule § __.6(e) (pp. 20-22 of Attachment A); Attachment B (pp. 408-432 of Attachment B).

²⁶ See final rule § __.6(e)(3)(i) – (v) (p. 22 of Attachment A); Attachment B (pp. 420-432 of Attachment B).

clearing facilities allows these exchanges and facilities – which are generally not subject to section 13 and do not take the risks section 13 is designed to address – to serve the widest possible range of counterparties and enhances financial stability in the U.S. as well as safety and soundness. In particular, allowing access to U.S. exchanges and clearing facilities prevents the potential adverse impacts from possible reductions in competitiveness of or liquidity available on these regulated exchanges and facilities, which could also harm other U.S. market participants who trade on these exchanges and facilities. This approach is also consistent with and reinforces the goals of the central clearing framework of Title VIII of the Dodd-Frank Act.

In addition, trading on U.S. exchanges and clearing facilities promotes transparency and, conversely, prohibiting foreign banking entities from trading on U.S. exchanges and clearing facilities would likely reduce transparency for trading in financial instruments in the U.S. At the same time, to the extent U.S. intermediaries that might be a counterparty to foreign banking entities as participants in the exchange or central counterparty are U.S. banking entities subject to section 13 of the BHC Act, those U.S. banking entities would remain subject to all the restrictions of the draft final rule. Consequently, the exemption would not introduce new risks to the U.S. financial system. All of these considerations support the Agencies' exercise of their exemptive authority under section 13(d)(1)(J) to allow such trading by foreign banking entities on U.S. exchanges and clearing facilities as provided in the final rule.

The statute does not make this exemption available to U.S. banking entities or their foreign subsidiaries and affiliates. By statute, the prohibition on proprietary trading applies to the consolidated, worldwide operations of U.S. firms. The foreign subsidiaries or affiliates of a U.S. banking entity may engage in trading activity with a foreign banking entity outside of the United States so long

as the foreign subsidiary or affiliate of the U.S. banking entity conducts the activity in accordance with the provisions of the final rule other than the SOTUS exemption.

7. Other exempt trading activities. Consistent with the statute, the final rule also implements exemptions for:

- Trading in U.S., State, municipal and GSE obligations, though this exemption does not extend to derivatives on those obligations;²⁷ and
- Trading on behalf of customers, including trading as riskless principal, or trustee or in a similar fiduciary capacity on behalf of unaffiliated third parties;²⁸

The final rule also provides exemptions that permit:

- Trading by the U.S. operations of a foreign banking entity, other than an insured depository institution, in obligations of the home chartering authority of the foreign banking entity (including obligations of any agency or political subdivision thereof);²⁹ and
- Trading by a foreign bank or foreign securities broker-dealer owned by a U.S. banking entity in obligations of the foreign sovereign that charters the foreign bank or foreign broker-dealer (including obligations of any agency or political subdivision thereof).³⁰

These last two exemptions are provided under the discretionary authority granted the Agencies under section 13(d)(1)(J) of the BHC Act. These exemptions are designed to promote and protect the safety and soundness of a banking entity and

²⁷ See final rule § __.6(a) (p. 18 of Attachment A); Attachment B (pp. 362-368, 381-388 of Attachment B).

²⁸ See final rule § __.6(c) (p. 19 of Attachment A); Attachment B (pp. 395-400 of Attachment B).

²⁹ See final rule § __.6(b)(1) (p. 18 of Attachment A); Attachment B (pp. 375-381 of Attachment B).

³⁰ See final rule § __.6(b)(2) (p. 19 of Attachment A); Attachment B (pp. 377-381 of Attachment B).

the financial stability of the United States.³¹ The first exemption promotes safety and soundness and financial stability by allowing the U.S. non-insured depository institution operations of foreign banking entities to facilitate the depth and liquidity of sovereign debt of the foreign sovereign that charters the foreign banking entity (roughly parallel to the exemption for trading in U.S. obligations). The second exemption similarly promotes safety and soundness and financial stability by allowing U.S. banking entities to own and operate banks and securities broker-dealers overseas that are permitted to facilitate liquidity in the sovereign debt of the foreign sovereign that charters that foreign entity. In both cases, the exemptions also facilitate the ability of a foreign entity to meet various regulatory and legal requirements in the foreign entity's home country.

The final rule also provides an exemption for trading in obligations of the FDIC, or any entity formed by or on behalf of the FDIC for purpose of facilitating the disposal of assets acquired or held by the FDIC in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Act.³² An exemption that would allow banking entities to trade in these types of obligations would promote and protect the safety and soundness of banking entities and the financial stability of the United States by increasing the market for and liquidity of these instruments, thereby facilitating the FDIC's access to funding for resolutions and its ability to conduct receivership and conservatorship operations in an orderly and less costly manner. This would also limit the risks to the financial system generally and promote safety and soundness by strengthening the FDIC and its guarantee.

³¹ See 12 U.S.C. § 1851(d)(1)(J).

³² See final rule § __.6(a)(4) (p. 18 of Attachment A); Attachment B (pp. 368-381 of Attachment B).

B. Prohibition and Restrictions on Ownership Interests in, and Certain Relationships with, Covered Funds

In addition to its prohibition on proprietary trading, section 13 of the BHC Act prohibits any banking entity from acquiring or retaining an ownership interest in, or having certain relationships with, a hedge fund or private equity fund.

Definition of “covered fund.” Section 13(h)(2) of the BHC Act covers any entity that would be an investment company under the Investment Company Act of 1940 but for the exclusions under sections 3(c)(1) or 3(c)(7) of that Act,³³ or such similar funds as the Agencies may, by rule, determine. The proposal adopted this definition with little interpretation and extended its coverage to all commodity pools and certain foreign funds. Many commenters argued that the proposed definition of covered fund was overly broad and would lead to anomalous results inconsistent with the words, structure, and purpose of section 13. In particular, commenters urged different interpretations of the statute and requested that the final rule exclude a number of common corporate entities that may not conventionally be thought of as a “hedge fund” or “private equity fund,” such as joint ventures, wholly-owned subsidiaries, and other entities that do not appear to be the focus of section 13. Commenters also argued that including all commodity pools would expand the definition of covered fund to include many commercial and other entities that are not hedge funds or private equity funds.

Staff of the Agencies believe that the language of section 13(h)(2) can best be interpreted to provide two alternative definitions of the entities covered by the statutory terms “hedge fund” and “private equity fund.” Under this reading, the

³³ The exclusions provided by section 3(c)(1) and 3(c)(7) are some of the most widely relied upon exclusions from the definition of investment company and exclude any issuer (i) whose securities are beneficially owned by not more than 100 persons, or (ii) the outstanding securities of which are owned exclusively by qualified purchasers, respectively. See 15 U.S.C. §§ 80a-3(c)(1) and (c)(7).

first part of section 13(h)(2) contains a base definition that references the noted exclusions under the Investment Company Act that would govern if the Agencies do not act under the second part which grants the Agencies the authority to adopt an alternate definition. As described in Appendix B, the final rule represents a determination by the Agencies to exercise the authority under the second part of the statute to define “hedge fund” and “private equity fund” in the final rule.³⁴

The final rule adopts a tailored definition of covered fund that covers issuers of the type that would be investment companies but for section 3(c)(1) or 3(c)(7) of the Investment Company Act. The final rule also covers commodity pools that share the characteristics of an entity excluded from the Investment Company Act under the exclusions in section 3(c)(1) or 3(c)(7) and foreign funds that are similar to U.S. covered funds.³⁵

The final rule also excludes from its coverage a number of entities that are not engaged in the types of investments or activities that section 13 of the BHC Act is designed to address. In particular, the final rule excludes from the definition of covered fund such entities as foreign public funds, wholly-owned subsidiaries; joint ventures that do not engage in investing money for others; acquisition vehicles; foreign pension or retirement funds; insurance company separate accounts; SBICs and public welfare investment funds; and registered investment companies.³⁶ The final rule also permits the Agencies, jointly, to rescind an exclusion if it is being used to evade the requirements of the statute or to exclude other entities from the definition of covered fund if appropriate.

³⁴ See Attachment B (p. 476-480 of Attachment B).

³⁵ See final rule § __.10(b) (pp. 24-25 of Attachment A); Attachment B (pp. 486-495 of Attachment B).

³⁶ See final rule § __.10(c) (pp. 25-31 of Attachment A); Attachment B (pp. 495-583 of Attachment B).

Exemptions from the prohibition on ownership of a covered fund.

The statute provides exemptions from the covered fund activities prohibition for a number of activities, including:

- Investing in a covered fund in connection with organizing and offering the covered fund for customers of the banking entity's trust, fiduciary, or advisory services;
- Underwriting and market making-related activities that are designed not to exceed the reasonably expected near term demands of clients, customers, and counterparties;
- Risk-mitigating hedging activities;
- Trading for the general account of a registered insurance company;
- Trading on behalf of customers;
- Sponsoring and investing in loan securitizations;³⁷ and
- Any activity with a covered fund by a foreign banking entity solely outside of the United States.³⁸

As with proprietary trading, section 13 permits the Agencies to exempt, by rule, any other activity or investment that the Agencies determine promotes and protects the safety and soundness of banking entities and the financial stability of the United States.³⁹

1. Permitted organizing and offering of a covered fund. As provided in the statute, the final rule permits a banking entity to acquire and retain an ownership interest in a covered fund in connection with organizing and offering

³⁷ The statute contains a rule of construction which provides that nothing in section 13 of the BHC Act shall be construed to limit or restrict the ability of a banking entity to sell or securitize loans in a manner otherwise permitted by law. See 12 U.S.C. § 1851(g)(2).

³⁸ See 12 U.S.C. § 1851(d)(1).

³⁹ See id. at § 1851(d)(1)(J).

the covered fund so long as certain requirements are met. In order to qualify for this exemption, a banking entity must provide bona fide trust, fiduciary, or advisory services, and may only offer ownership interests in the covered fund to customers of these trust, fiduciary or advisory services. Since the statute does not explicitly require that the customer relationship be pre-existing, the final rule provides that the customer relationship for these services may be established through or in connection with the organization and offering of the covered fund.⁴⁰ In order to ensure that a banking entity organizes and offers a covered fund for its customers and not to evade the restrictions contained in the statute, the final rule provides that the banking entity must develop a written plan or similar documentation outlining how the banking entity intends to provide advisory or similar services to its customers through the fund.

As provided in the statute, the final rule provides this exemption only if the banking entity does not directly or indirectly guarantee, assume, or otherwise insure the obligations or performance of the fund or any covered fund in which such fund invests. In addition, the banking entity must make specified written disclosures to investors,⁴¹ and the fund may not share the same name or a variation of the same name with the banking entity for corporate, marketing, promotion, or

⁴⁰ See final rule § __.11(a)(2) (p. 34 of Attachment A); Attachment B (pp. 641-644 of Attachment B).

⁴¹ See final rule §§ __.11(a)(5), (8) (p. 35 of Attachment A); Attachment B (pp. 646-647, 657-659 of Attachment B). The disclosures required by the final rule are designed to ensure that investors in the covered fund understand the nature of their investment and that any losses in the covered fund, other than the banking entity's permitted *de minimis* investment, are borne solely by investors in the covered fund and not by the banking entity.

other purposes or use the word “bank” in its name.⁴² The banking entity is also subject to a number of investment limits discussed in more detail below.

As noted above, section 13(d)(1)(J) of the BHC Act permits the Agencies to grant an exemption to permit any activity that promotes and protects the safety and soundness of a banking entity and the financial stability of the United States.⁴³ Using this authority, the final rule permits a banking entity to own an interest in a securitization vehicle that the banking entity organizes and offers so long as the banking entity complies with the restrictions noted above with two exceptions. First, the banking entity is not required to offer ownership interests only to customers of trust, fiduciary, or investment advisory services; unlike typical private equity or hedge funds, which generally are managed funds that reflect the investment advice of the banking entities, securitizations are typically static pools of assets acquired for investment. Without an exemption, banking entities would not be permitted to own an interest in securitizations that are covered funds and this valuable method of gathering capital to support non-security assets would be largely impossible. Second, as described more fully below, section 13 limits a banking entity’s ownership of a covered fund to no more than 3 percent of the covered fund’s ownership interests; however any securitizer (including a banking entity) for a securitization (including an issuer that is a covered fund) is required by section 15G of the Exchange Act (as added by the Dodd-Frank Act) to retain a

⁴² See final rule § __.11(a)(6) (p. 35 of Attachment A); Attachment B (pp. 647-652 of Attachment B). Similar restrictions on namesharing with respect to a fund have been used previously by the Board in order to prevent customer confusion regarding the relationship between a bank holding company and a fund. See e.g., Bank of Ireland, 82 Fed. Res. Bull. 1129 (1996); 12 CFR 225.125.

⁴³ See 12 U.S.C. § 1851(d)(1)(J).

specified amount of risk in the securitization, typically 5 percent. The exemption permits a banking entity to meet that statutory requirement.⁴⁴

2. Permitted investments in a covered fund. The statute and final rule permit a banking entity to invest any amount in a covered fund so long as the banking entity's investment in the fund does not, after one year from the date the fund is established,⁴⁵ exceed 3 percent of the total outstanding ownership interests in the fund (the "per-fund limitation"). The final rule provides that this per-fund limitation is calculated based on both the number of ownership interests and the value of ownership interests held by the banking entity in a covered fund, compared to the number or value, respectively, of all investments or capital contributions made by all persons in that covered fund.⁴⁶ In calculating the per-fund investment limitation, a banking entity must use fair market value of the interests in the fund or, if fair market value cannot be determined, historical cost. In order to prevent evasion of the limitations in section 13, the final rule attributes any ownership interest held by an employee or director of the banking entity if the banking entity finances the purchase of those ownership interests.⁴⁷

The final rule also provides that a banking entity that sponsors, has an advisory relationship with, or provides a guarantee to a covered fund must include

⁴⁴ See Credit Risk Retention, 76 FR 24,090 (Apr. 29, 2011).

⁴⁵ See final rule § __.12(a)(2)(i) (p. 37 of Attachment A); Attachment B (pp. 652-657 of Attachment B). As authorized by the statute, the final rule permits the Board to grant up to two, one-year extensions of the period in which a banking entity must conform its investment to the per-fund limitation. See final rule § __.12(e) (pp. 41-43 of Attachment A); Attachment B (pp. 670-675, 715-718 of Attachment B).

⁴⁶ See final rule § __.12(b) (pp. 38-40 of Attachment A); Attachment B (pp. 675-690 of Attachment B).

⁴⁷ See final rule § __.12(b)(1)(iv) (p. 38 of Attachment A); Attachment B (pp. 706-709 of Attachment B).

any ownership interest it holds under the underwriting or market making exemptions in calculating compliance with the 3 percent per fund, aggregate total and capital deduction limitations governing ownership of covered funds. This would have the effect of limiting the aggregate amount of ownership interests of a covered fund that a banking entity may underwrite or make a market in to 3 percent of the ownership interests of the covered fund if the banking entity is simultaneously an investment advisor or sponsor of the covered fund.⁴⁸

The final rule permits a banking entity to hold ownership interests in a securitization up to the amount required to comply with the minimum requirements of section 15G of the Exchange Act and any implementing regulations issued thereunder. Section 15G generally requires the securitizer to retain ownership interests that represent 5 percent of the risk of the securitization.

The limits in the statute apply to “ownership interests” in covered funds. The final rule defines “ownership interest” broadly to include any equity, partnership, or other similar interest in a covered fund that exhibits certain features or characteristics that are indicative of ownership of a covered fund.⁴⁹

Many banking entities are compensated for advisory services they provide to a covered fund through a generally non-transferrable instrument or contract that is designed to incentivize the investment advisor to make profitable investments by fluctuating in value with the success of the fund. These restricted profit interests are designed to ensure that the interests of the investment advisor to a fund are aligned with the interests of the investors. The final rule provides an exclusion from the definition of “ownership interest” for these types of incentive

⁴⁸ See final rule § __.11(c) (p. 36 of Attachment A); Attachment B (pp. 664-669 of Attachment B).

⁴⁹ See final rule § __.10(d)(6) (pp. 32-33 of Attachment A); Attachment B (pp. 606-612 of Attachment B).

arrangements. To be exempt, the interest must be provided to the banking entity or employee thereof solely as performance compensation for services provided by the banking entity or employee to the covered fund, and any profit, once allocated, must be distributed promptly after being earned or, if not distributed, may not share in subsequent investment gains of the fund (i.e., allocated profit may not be reinvested into the fund).⁵⁰ In addition, any funds provided in connection with acquiring or retaining the interest must be included for purposes of calculating the banking entity's permitted investment in the fund. Finally, the instrument may not be transferrable except under limited circumstances (such as to an affiliate, upon death of the employee, or upon sale of the business that provides advisory services to the fund).

The statute and the final rule also provide that a banking entity's aggregate investments in all covered funds may not exceed 3 percent of the banking entity's applicable tier 1 capital (the "aggregate funds limitation").⁵¹ For purposes of determining the aggregate funds limitation, a banking entity must use the historical cost of its investments. In determining compliance with the aggregate funds limitation, any banking entity that calculates and reports tier 1 capital must apply the banking entity's tier 1 capital as of the last day of the most recent calendar quarter that has ended, as reported to the relevant Federal banking agency.⁵² Since not all banking entities calculate and report tier 1 capital, the final rule provides that the aggregate funds limitation will be calculated for entities that are not

⁵⁰ See final rule § __.10(d)(6)(ii) (pp. 32-33 of Attachment A); Attachment B (pp. 616-621 of Attachment B).

⁵¹ See final rule § __.12(c)(1) (p. 40 of Attachment A); Attachment B (pp. 690-695 Attachment B).

⁵² See final rule § __.12(c)(2)(i) (p. 40 of Attachment A); Attachment B (pp. 690-695, 711-715 of Attachment B).

required to calculate and report tier 1 capital based on the shareholders' equity of the top-tier entity of the organization as of the last day of the most recent calendar quarter that has ended.⁵³

Additionally and consistent with the statute, the final rule requires that a banking entity's investment in a covered fund, including retained earnings, be deducted from the tier 1 capital of the banking entity for purposes of regulatory capital standards.⁵⁴ For purposes of this deduction, a banking entity must deduct the greater of fair market value or historical cost, including any earnings received.

3. Permitted foreign covered fund activities. As does the statute, the final rule permits a foreign banking organization to acquire or retain any ownership interest in, or act as sponsor to, a covered fund so long as the activity is: (i) conducted "solely outside of the United States"; and (ii) no ownership interest in the covered fund is offered for sale or sold to a resident of the United States.⁵⁵

The final rule permits a foreign banking entity to rely on this exemption only if:

- The banking entity (including relevant personnel) that makes the decision to invest or act as sponsor is not located in the United States;
- The investment or sponsorship, including any related hedging transactions, is not accounted for as principal in the United States;
- Ownership interests in the covered fund are not targeted to residents of the United States; and

⁵³ See final rule § __.12(c)(2)(ii) (pp. 40-41 of Attachment A); Attachment B (pp. 711-715 of Attachment B).

⁵⁴ See 12 U.S.C. § 1851(d)(4)(B)(iii); final rule § __.12(d) (p. 41 of Attachment A); Attachment B (pp. 695-701 of Attachment B).

⁵⁵ See final rule § __.13(b) (pp. 44-45 of Attachment A); Attachment B (pp. 724-744 of Attachment B).

- No financing for the banking entity’s ownership or sponsorship is provided by a U.S. affiliate of the foreign banking entity.⁵⁶

As with the exemption discussed above for foreign proprietary trading by foreign-based firms, this exemption is not available to U.S. banking entities or their foreign subsidiaries and affiliates. By statute, the prohibition on covered fund activities and investments applies to the consolidated, worldwide operations of U.S. firms.

4. Other permitted covered fund activities. The statute provides that it is not to be construed to limit or restrict the ability of a banking entity to sell or securitize loans in a manner otherwise permitted by law. Based on this provision, the final rule exempts loan securitizations that are comprised only of loans and related servicing assets. All other types of securitizations, including securitizations of securities (e.g., CDOs and municipal securities) or other assets (e.g., real estate or intellectual property) may be covered funds under the rule.

In addition to the activities specified above, the final rule permits the use of ownership interests in a covered fund as a hedging instrument only if the hedging activity is directly connected to a compensation arrangement with an employee who directly provides investment advisory or other services to the covered fund.⁵⁷

⁵⁶ The final rule would, however, allow a U.S.-based employee or subsidiary of the foreign banking entity to perform so-called “back office” administrative functions, such as clearing and settlement or maintaining and preserving records of the fund, so long as the employee or subsidiary is solely involved in providing administrative services to, and does not have any customer relationship with investors in the fund, and the transaction is not booked on the accounts of a U.S. entity.

⁵⁷ This authority and the relevant limitations associated with it are discussed in greater detail on pages 15-17 of Attachment A. See final rule § __.13(a) (pp. 43-44 of Attachment A); Attachment B (pp. 718-724 of Attachment B).

The final rule permits a banking entity that is an insurance company or an affiliate of the insurance company to acquire or retain an ownership interest in, and act as sponsor to, a covered fund for the general account or a separate account of a regulated insurance company.⁵⁸

5. Limitations on permitted covered fund activities and investments.

The statute prohibits any banking entity that serves as the investment manager, adviser, or sponsor to a covered fund from entering into a transaction with the covered fund that would be a covered transaction for purposes of section 23A of the Federal Reserve Act.⁵⁹ The statute does not incorporate the general exemption provided in section 23A for transactions that represent less than 10 percent of the banking entity's capital and surplus. Instead, the statute and the final rule provide only a narrow exemption to this general prohibition for a prime brokerage transaction with a covered fund that is owned by another covered fund sponsored or advised by the banking entity (a so-called "second-tier fund").⁶⁰

Permitted prime brokerage transactions would be subject to section 23B of the Federal Reserve Act. Therefore, these permitted relationships must be on terms and under circumstances that are substantially the same or at least as favorable to the banking entity as those prevailing at the time for comparable

⁵⁸ See final rule § __.13(c) (pp. 45-46 of Attachment A); Attachment B (pp. 744-749 of Attachment B).

⁵⁹ See 12 U.S.C. § 1851(f)(3); final rule § __.14(a)(1) (p. 46 of Attachment A); Attachment B (pp. 749-763 of Attachment B).

⁶⁰ See final rule § __.14(a)(2) (p. 46 of Attachment A). The final rule defines prime brokerage transaction to include any transactions that would be a covered transaction, as defined in section 23A(b)(7) of the Federal Reserve Act, that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support. See final rule § __.10(d)(7) (p. 33 of Attachment A); Attachment B (pp. 757-763 of Attachment B).

transactions with or involving other unaffiliated companies, or that in good faith would be offered or would apply to unaffiliated companies.⁶¹

As under the statute, the final rule does not incorporate or reference the exemptions contained in section 23A of the Federal Reserve Act or the Board's Regulation W. The exemptions for these transactions are not included in the definition of covered transactions in section 23A (which is the term referenced by section 13 of the BHC Act); rather, the exemptions are in a different subsection of section 23A and provide an exemption from only some (but not all) of the provisions of section 23A.⁶² Therefore, the final rule does not incorporate the exemptions in section 23A.

Similarly, the final rule incorporates the statutory language as written, which provides that a banking entity subject to section 13(f) may not enter into a transaction with the fund that would be a covered transaction as defined under section 23A.⁶³ Therefore, the final rule does not prohibit a banking entity from extending credit to a customer secured by shares of a covered fund (as well as, perhaps, other securities) held in a margin account.

C. Restrictions on all permitted activities

The statute prohibits a banking entity from engaging in an activity or making an investment if the activity or investment would pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States, or

⁶¹ See final rule §§ __.14(b), (c) (pp. 46-47 of Attachment A); Attachment B (pp. 762-763 of Attachment B).

⁶² See 12 U.S.C. § 371c(b)(7); see also 12 U.S.C. § 371c-1(a)(2)(B) (including the sale of securities or other assets to an affiliate as a transaction subject to section 23B); Attachment B (pp. 752-756 of Attachment B).

⁶³ See 12 U.S.C. § 1851(f)(1).

if the activity or investment involves a “material conflict of interest with customers, client or counterparties” or “high-risk assets or trading strategies.”⁶⁴

Under the final rule, a banking entity would have a “material conflict of interest” if the banking entity’s interests are materially adverse to the interests of its client, customer, or counterparty in a transaction or activity, unless the banking entity (i) makes timely disclosure to the client, customer or counterparty of clear and meaningful information regarding the conflict, or (ii) uses information barriers, such as physical separation of personnel or functions, that address the conflict.⁶⁵

The final rule also prohibits any transaction or activity that would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies, each of which are defined as a transaction or strategy that would substantially increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.⁶⁶ Given that the rapidly-evolving and dynamic nature of the markets would likely render a specific list obsolete or susceptible to arbitrage over time, the final rule does not include a specific list of prohibited material conflicts of interest, high-risk assets, and high-risk trading strategies. Instead, the final rule contemplates that the Agencies would rely on the supervisory process to identify these conflicts, assets, and strategies.

⁶⁴ See 12 U.S.C. § 1851(d)(2); Attachment B (pp. 432-462, 763-765 of Attachment B).

⁶⁵ See final rule §§ __.7(b), 15(b) (pp. 22-23, 48 of Attachment A); Attachment B (pp. 434-457 of Attachment B). The final rule does not address instances where a banking entity makes a material misrepresentation to its client, customer, or counterparty in connection with a transaction or activity, since such transactions or activity appear to involve fraud rather than a conflict of interest and are illegal in the first instance.

⁶⁶ See final rule §§ __.7(c), 15(c) (pp. 23, 48 of Attachment A); Attachment B (pp. 457-462 of Attachment B).

D. Compliance Program Requirements and Rulemaking Framework

The final rule requires banking entities engaged in proprietary trading or covered fund activities and investments to develop and provide for the continued administration of a compliance program reasonably designed to ensure and monitor compliance with the final rule and section 13 of the BHC Act. The compliance program requirements have been tailored under the final rule to the size and complexity of the banking entity.

To minimize burden, the final rule provides that a banking entity that does not engage in covered trading activities (other than trading in U.S. government or agency obligations, obligations of specified government sponsored entities, and state and municipal obligations) or covered fund activities and investments is not required to establish a compliance program prior to becoming engaged in such activities or making such investments.⁶⁷ In addition, to minimize burden on smaller banking entities, a banking entity with total consolidated assets of \$10 billion or less that engages in covered trading activities and/or covered fund activities may satisfy the compliance program requirements of the final rule by including in its existing compliance policies and procedures appropriate references to the requirements of section 13 and the final rule and adjustments as appropriate given the activities, size, scope and complexity of the banking entity.⁶⁸

For banking entities with \$10 billion or more in total assets, the final rule specifies six elements that each compliance program must, at a minimum, include. Those elements are:

⁶⁷ See final rule § __.20(f)(1), (p. 51 of Attachment A); Attachment B (pp. 779-781 of Attachment B).

⁶⁸ See final rule § __.20(f)(2), (p. 51 of Attachment A); Attachment B (pp. 779-781 of Attachment B).

- Written policies and procedures that establish trading and exposure limits for the activities conducted by the banking entity and are designed to ensure compliance with the requirements of the final rule;
- Internal controls;
- A management framework that delineates responsibility and accountability for compliance with the final rule;
- Independent testing and audit;
- Training; and
- Recordkeeping.⁶⁹

For any banking entity with significant covered trading or covered fund operations,⁷⁰ the final rule requires that the compliance program satisfy a variety of additional requirements and minimum standards generally designed to ensure that the banking entity has robust risk management processes, remediation processes, independent testing and reporting, and other compliance controls to govern its covered trading and covered fund activities.⁷¹ Among these enhanced requirements is that the CEO of a banking entity with significant trading or covered funds activities or investments must, annually, attest in writing to the relevant agency that the banking entity has in place a compliance program reasonably designed to achieve compliance with section 13 and the final rule.

CEO attestation and other enhanced minimum standards are applicable to any banking entity that has reported total consolidated assets as of the previous calendar year end of \$50 billion or more or, in the case of a foreign banking entity,

⁶⁹ See final rule § __.20(a), (b) (pp. 48-49 of Attachment A); Attachment B (pp. 775-779 of Attachment B).

⁷⁰ See final rule § __.20(c); Appendix B (pp. 781-790 of Attachment B).

⁷¹ See final rule § __.20(c), Appendix B (pp. 49, 62-71 of Attachment A); Attachment B (pp. 790-806 of Attachment B).

has total U.S. assets as of the previous calendar year end of \$50 billion or more (including all subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the United States). They are also applicable to any banking entity that is subject to the metrics reporting requirements of Appendix A of the final rule as explained below or that the appropriate agency notifies in writing that it is subject to the additional standards.

The application of detailed minimum standards for these types of banking entities is intended to reflect the heightened compliance risks of significant covered trading activities of covered fund activities and investments and to provide clear, specific guidance to such banking entities regarding the compliance measures that would be required under the final rule.

E. Metrics Reporting.

The final rule requires banking entities with significant trading operations to furnish the relevant Agency a variety of metrics designed to help firms and regulators monitor and identify prohibited proprietary trading and high risk trading strategies.⁷² In order to minimize burden and give full effect to the conformance period provisions of section 13, the reporting requirements are applied in a graduated manner, with only the very largest firms required to report metrics. The final rule requires reporting of these metrics beginning with data for July 2014. In particular, a banking entity must comply with the metrics reporting requirements only if the banking entity has worldwide trading assets and liabilities (excluding trading assets and liabilities involving obligations of or guaranteed by the U.S. government or any agency of the United States) of \$50 billion or more; with respect to a foreign banking entity, the same threshold is applied to the trading assets and liabilities of the U.S. operations of the foreign banking entity.

⁷² See final rule Appendix A (pp. 53-61 of Attachment A); Attachment B (pp. 806-855 of Attachment B).

Beginning on April 30, 2016, this threshold drops to \$25 billion in applicable trading assets and liabilities; and then to \$10 billion beginning on December 31, 2016. The preamble states that the Agencies will revisit the metrics and revise them as necessary based on data received by September 30, 2015. Approximately 8 U.S. banking entities and 16 foreign banking entities would meet the \$10 billion threshold.

The final rule reduces the number of metrics to be reported from 17 to 7 that provide the most useful information about a trading desk's activity.⁷³ These metrics include:

- 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 – trade count based and value based.

The preamble to the final rule makes clear that metrics are designed to be a tool for triggering further scrutiny by banking entities and examiners in their evaluation of whether a banking entity is engaging in prohibited proprietary trading, engaging in high risk trading strategies, or maintaining exposures to high risk assets. The final rule does not propose specific thresholds for individual metrics.⁷⁴

⁷³ See final rule Appendix A (pp. 53-61 of Attachment A); Attachment B (pp. 823-855 of Attachment B).

⁷⁴ See Attachment B (pp. 827-828 of Attachment B).

Although the quantitative measurements include many that banking entities already calculate for internal risk management or other purposes (e.g., Value-at-Risk or risk factor sensitivities), calculating and reporting the metrics according to the standardized specifications described in the final rule is likely to require banking entities to create and implement new processes. Creating and implementing these processes may entail, even for the largest firms, compliance costs and burdens.⁷⁵

Accordingly, the final rule delays the reporting requirements for these metrics until July 2014. These requirements have been included because they represent an effective means of faithfully implementing and enforcing the statutory prohibition on proprietary trading short of prescribing specific, standardized limits on the amount of inventory or principal risk that an underwriter or market maker may retain, which would be likely to unduly constrain the efficiency and liquidity of trading markets.⁷⁶

F. Conformance Provisions.

As noted above, the restrictions and prohibitions of section 13 of the BHC Act became effective on July 21, 2012.⁷⁷ The statute provides banking entities a period of two years to conform their activities and investments to the requirement of the statute. Section 13 also permits the Board to extend this conformance period, one year at a time, for a total of no more than three additional years.⁷⁸

⁷⁵ As noted above, the final rule would not require smaller, less-complex banking entities to calculate or report such quantitative measurements.

⁷⁶ See Attachment B (pp. 823-828 of Attachment B).

⁷⁷ See 12 U.S.C. 1851(c)(1).

⁷⁸ See 12 U.S.C. 1851(c)(2); see also Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 FR 8265 (Feb. 14, 2011) (citing 156 Cong. Rec. S5898 (daily ed. July 15, 2010) (statement of Sen. Merkley)).

Many commenters requested that, prior to or in connection with issuing a final rule, the Board extend the conformance period by an additional year.

Pursuant to this authority in section 13 of the BHC Act, and in connection with this rulemaking, the attached Order (Attachment D) provides banking entities with additional time to conform their activities and investments to the statute and the final rule by extending the conformance period for one additional year until July 21, 2015.⁷⁹ This will allow banking entities to develop appropriate compliance programs and develop and impose appropriate limits, and identify and conform activities and investments to the requirements of the final rule.

CONCLUSION: Staff recommends that the Board adopt the attached draft final rule and related Federal Register notice. Staff also recommends that the Board approve the attached Order extending the conformance period under section 13 of the BHC Act for all banking entities until July 21, 2015. Staff also requests authority to make minor and technical changes to the draft final rule and Federal Register notice prior to publication (for example, to incorporate changes requested by other Agencies as part of the approval process, or to address any changes that may be requested by the Federal Register).

Attachments

⁷⁹ See Attachment D; Attachment B (p. 9 of Attachment B).