

DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Part 44
Docket No. OCC-2011-0014
RIN: 1557-AD44

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
12 CFR Part [•]
Docket No. R-14[•]
RIN: 7100 AD[•]

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 351
RIN: 3064-AD85

SECURITIES AND EXCHANGE COMMISSION
17 CFR Part [•]
Release No. 34-[•]; File No. [•]
RIN: 3235-AK[•]

PROHIBITIONS AND RESTRICTIONS ON PROPRIETARY TRADING AND CERTAIN INTERESTS IN, AND RELATIONSHIPS WITH, HEDGE FUNDS AND PRIVATE EQUITY FUNDS

AGENCIES: Office of the Comptroller of the Currency, Treasury (“OCC”); Board of Governors of the Federal Reserve System (“Board”); Federal Deposit Insurance Corporation (“FDIC”); and Securities and Exchange Commission (“SEC”).

ACTION: Notice of proposed rulemaking.

SUMMARY: The OCC, Board, FDIC, and SEC (individually, an “Agency,” and collectively, “the Agencies”) are requesting comment on a proposed rule that would implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) which contains certain prohibitions and restrictions on the ability of a banking entity and nonbank financial company supervised by the Board to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund.

DATES: Comments should be received on or before [December 16], 2011.

ADDRESSES: Interested parties are encouraged to submit written comments jointly to all of the Agencies. Commenters are encouraged to use the title “Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds” to facilitate the organization and distribution of comments among the Agencies. Commenters are also encouraged to identify the number of the specific question for comment to which they are responding.

Office of the Comptroller of the Currency: Because paper mail in the Washington, DC area and at the OCC is subject to delay, commenters are encouraged to submit comments by the Federal eRulemaking Portal or e-mail, if possible. Please use the title “Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds” to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- **Federal eRulemaking Portal – “Regulations.gov”**: Go to <http://www.regulations.gov>. Select “Document Type” of “Proposed Rules,” and in the “Enter Keyword or ID Box,” enter Docket ID “OCC-2011-14,” and click “Search.” On “View By Relevance” tab at the bottom of screen, in the “Agency” column, locate the Proposed Rule for the OCC, in the “Action” column, click on “Submit a Comment” or “Open Docket Folder” to submit or view public comments and to view supporting and related materials for this rulemaking action.
- Click on the “Help” tab on the Regulations.gov home page to get information on using Regulations.gov, including instructions for submitting or viewing public comments, viewing other supporting and related materials, and viewing the docket after the close of the comment period.
- **E-mail**: regs.comments@occ.treas.gov.
- **Mail**: Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 2-3, Washington, DC 20219.
- **Fax**: (202) 874-5274.
- **Hand Delivery/Courier**: 250 E Street, SW., Mail Stop 2-3, Washington, DC 20219.

Instructions: You must include “OCC” as the agency name and “Docket ID OCC-2011-14” in your comment. In general, OCC will enter all comments received into the docket and publish them on the Regulations.gov web site without change, including any business or personal information that you provide such as name and address information, e-mail addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this proposed rulemaking by any of the following methods:

- **Viewing Comments Electronically**: Go to <http://www.regulations.gov>. Select “Document Type” of “Public Submissions,” and in the “Enter Keyword or ID Box,” enter Docket ID “OCC-2011-14,” and click “Search.” Comments will be listed under “View By Relevance” tab at the bottom of screen. If comments from more than one agency are listed, the “Agency” column will indicate which comments were received by the OCC.

- **Viewing Comments Personally:** You may personally inspect and photocopy comments at the OCC, 250 E Street, SW., Washington, DC 20219. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 874-4700. Upon arrival, visitors will be required to present valid government-issued photo identification and submit to security screening in order to inspect and photocopy comments.

Docket: You may also view or request available background documents and project summaries using the methods described above.

Board of Governors of the Federal Reserve System:

You may submit comments, identified by **Docket No. R-14[•]** and **RIN 7100 AD[•]**, by any of the following methods:

- **Agency Web Site:** <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.
- **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.
- **E-mail:** regs.comments@federalreserve.gov. Include the docket number in the subject line of the message.
- **Fax:** (202) 452-3819 or (202) 452-3102.
- **Mail:** Address to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments will be made available on the Board's web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, unless modified for technical reasons. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, NW.) between 9:00 a.m. and 5:00 p.m. on weekdays.

Federal Deposit Insurance Corporation: You may submit comments, identified by RIN number, by any of the following methods:

- **Agency Web Site:** <http://www.fdic.gov/regulations/laws/federal/propose.html>. Follow instructions for submitting comments on the Agency Web Site.
- **E-mail:** Comments@fdic.gov. Include the RIN number 3064-AD85 on the subject line of the message.
- **Mail:** Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

- **Hand Delivery:** Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7:00 a.m. and 5:00 p.m.

Public Inspection: All comments received must include the agency name and RIN 3064-AD85 for this rulemaking. All comments received will be posted without change to <http://www.fdic.gov/regulations/laws/federal/propose.html>, including any personal information provided. Paper copies of public comments may be ordered from the FDIC Public Information Center, 3501 North Fairfax Drive, Room E-I002, Arlington, VA 22226 by telephone at 1 (877) 275-3342 or 1 (703) 562-2200.

Securities and Exchange Commission: You may submit comments by the following method:

Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number [•] on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number [•]. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT:

OCC: Deborah Katz, Assistant Director, or Ursula Pfeil, Counsel, Legislative and Regulatory Activities Division, (202) 874-5090; Roman Goldstein, Senior Attorney, Securities and Corporate Practices Division, (202) 874-5210; Kurt Wilhelm, Director for Financial Markets Group, (202) 874-4660; Stephanie Boccio, Technical Expert for Asset Management Group, or

Joel Miller, Group Leader for Asset Management Group, (202) 874-4660, Office of the Comptroller of the Currency, 250 E Street SW., Washington, DC 20219.

Board: Jeremy R. Newell, Counsel, (202) 452-3239, or Christopher M. Paridon, Counsel, Legal Division, (202) 452-3274; Sean D. Campbell, Deputy Associate Director, Division of Research and Statistics, (202) 452-3761; David Lynch, Manager, Division of Bank Supervision and Regulation, (202) 452-2081, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

FDIC: Bobby R. Bean, Acting Associate Director, Capital Markets (202) 898-6705, or Karl R. Reitz, Senior Capital Markets Specialist, (202) 898-6775, Division of Risk Management Supervision; Michael B. Phillips, Counsel, (202) 898-3581, or Gregory S. Feder, Counsel, (202) 898-8724, Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429-0002.

SEC: Josephine Tao, Assistant Director, Elizabeth Sandoe, Senior Special Counsel, David Bloom, Branch Chief, Anthony Kelly, Special Counsel, Angela Moudy, Attorney Advisor, or Daniel Staroselsky, Attorney Advisor, Office of Trading Practices, Division of Trading and Markets, (202) 551-5720; Gregg Berman, Senior Advisor to the Director, Division of Trading and Markets; Daniel S. Kahl, Assistant Director, Tram N. Nguyen, Branch Chief, Michael J. Spratt, Senior Counsel, or Parisa Hagshenas, Law Clerk, Office of Investment Adviser Regulation, Division of Investment Management, (202) 551-6787; David Beaning, Special Counsel, Office of Structured Finance, Division of Corporation Finance, (202) 551-3850; John Harrington, Special Counsel, Office of Capital Market Trends, Division of Corporation Finance, (202) 551-3860; Richard Bookstaber, Senior Policy Advisor, or Jennifer Marietta-Westberg, Assistant Director, Office of the Sell Side; or Adam Yonce, Financial Economist, Division of Risk Strategy and Financial Innovation, (202) 551-6600, U.S. Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

I. Background.

The Dodd-Frank Act was enacted on July 21, 2010.¹ Section 619 of the Dodd-Frank Act added a new section 13 to the Bank Holding Company Act of 1956 (“BHC Act”) (to be codified at 12 U.S.C. § 1851) that generally prohibits any banking entity² from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund (“covered fund”), subject to certain exemptions.³ New section 13 of the BHC Act also provides for nonbank financial companies

¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

² Application of the proposed rule to smaller, less-complex banking entities is discussed below in Part II.H of this Supplemental Information.

³ The term “banking entity” is defined in section 13(h)(1) of the BHC Act, as amended by section 619 of the Dodd-Frank Act. See 12 U.S.C. 1851(h)(1). The statutory definition includes any insured depository institution (other than certain limited purpose trust institutions), 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 of 1978 (12 U.S.C. 3106), and any affiliate or subsidiary of any of the foregoing. Section 13 of the BHC Act defines the terms “hedge fund” and “private equity fund” as an issuer that would be an investment company, as defined

supervised by the Board that engage in such activities or have such interests or relationships to be subject to additional capital requirements, quantitative limits, or other restrictions.⁴

A. Rulemaking framework.

Section 13 of the BHC Act requires that implementation of its provisions occur in several stages. First, the Council was required to conduct a study (“Council study”) and make recommendations by January 21, 2011 on the implementation of section 13 of the BHC Act. The Council study was issued on January 18, 2011, and included a detailed discussion of key issues related to implementation of section 13 and recommended that the Agencies consider taking a number of specified actions in issuing rules under section 13 of the BHC Act.⁵ The Council study also recommended that the Agencies adopt a four-part implementation and supervisory framework for identifying and preventing prohibited proprietary trading, which included a programmatic compliance regime requirement for banking entities, analysis and reporting of quantitative metrics by banking entities, supervisory review and oversight by the Agencies, and enforcement procedures for violations.⁶ The Agencies have carefully considered the Council study and its recommendations, and have consulted with the Commodity Futures Trading Commission (“CFTC”), in formulating this proposal.⁷

Authority for developing and adopting regulations to implement the prohibitions and restrictions of section 13 of the BHC Act is divided between the Agencies in the manner provided in section 13(b)(2) of the BHC Act.⁸ The statute also requires the Agencies, in

under the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*), but for section 3(c)(1) or 3(c)(7) of that Act, or any such similar funds as the appropriate Federal banking agencies (i.e., the Board, OCC, and FDIC), the SEC, and the CFTC may, by rule, determine should be treated as a hedge fund or private equity fund. See 12 U.S.C. 1851(h)(2).

⁴ See 12 U.S.C. 1851(a)(2) and (f)(4). A “nonbank financial company supervised by the Board” is a nonbank financial company or other company that the Financial Stability Oversight Council (“Council”) has determined, under section 113 of the Dodd-Frank Act, shall be subject to supervision by the Board and prudential standards. The Board is not proposing at this time any additional capital requirements, quantitative limits, or other restrictions on nonbank financial companies pursuant to section 13 of the BHC Act, as it believes doing so would be premature in light of the fact that the Council has not yet finalized the criteria for designation of, nor yet designated, any nonbank financial company.

⁵ See Financial Stability Oversight Counsel, Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds (Jan. 18, 2011), available at <http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20619%20study%20final%201%2018%2011%20r%20g.pdf>. See 12 U.S.C. 1851(b)(1). Prior to publishing its study, the Council requested public comment on a number of issues to assist the Council in conducting its study. See 75 FR 61,758 (Oct. 6, 2010). Approximately 8,000 comments were received from the public, including from members of Congress, trade associations, individual banking entities, consumer groups, and individuals. As noted in the issuing release for the Council Study, these comments were carefully considered by the Council when drafting the Council study.

⁶ See Council study at 5-6. The Agencies have implemented this recommendation through the proposed compliance program requirements contained in Subpart D of this proposal with respect to both proprietary trading and covered fund activities and investments.

⁷ The Agencies also received a number of comment letters concerning implementation of section 13 of the BHC Act in advance of this proposal. The Agencies have carefully considered these comments in formulating this proposal.

⁸ See 12 U.S.C. 1851(b)(2). Under section 13(b)(2)(B) of the BHC Act, rules implementing section 13’s prohibitions and restrictions must be issued by: (i) the appropriate Federal banking agencies (i.e., the Board, the

developing and issuing implementing rules, to consult and coordinate with each other, as appropriate, for the purposes of assuring, to the extent possible, that such rules are comparable and provide for consistent application and implementation of the applicable provisions of section 13 of the BHC Act.⁹ Such coordination will assist in ensuring that advantages are not unduly provided to, and that disadvantages are not unduly imposed upon, companies affected by section 13 of the BHC Act and that the safety and soundness of banking entities and nonbank financial companies supervised by the Board are protected. The statute requires the Agencies to implement rules under section 13 not later than 9 months after the Council completes its study (i.e., not later than October 18, 2011).¹⁰ The restrictions and prohibitions of section 13 of the BHC Act become effective 12 months after issuance of final rules by the Agencies, or July 21, 2012, whichever is earlier.¹¹

In addition, the statute required the Board, acting alone, to adopt rules to implement the provisions of section 13 of the BHC Act that provide a banking entity or a nonbank financial company supervised by the Board a period of time after the effective date of section 13 of the BHC Act to bring the activities, investments, and relationships of the banking entity into compliance with that section and the Agencies' implementing regulations.¹² The Board issued its final conformance rule as required under section 13(c)(6) of the BHC Act on February 8, 2011 ("Board's Conformance Rule").¹³ As noted in the issuing release for the Board's Conformance Rule, this period is intended to give markets and firms an opportunity to adjust to section 13 of the BHC Act.¹⁴

B. Section 13 of the BHC Act.

Section 13 of the BHC Act generally prohibits banking entities from engaging in proprietary trading or from acquiring or retaining any ownership interest in, or sponsoring, a covered fund.¹⁵ However, section 13(d)(1) of that Act expressly includes exemptions from these prohibitions for certain permitted activities, including:

OCC, and the FDIC), jointly, with respect to insured depository institutions; (ii) the Board, with respect to any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of section 8 of the International Banking Act, any nonbank financial company supervised by the Board, and any subsidiary of any of the foregoing (other than a subsidiary for which an appropriate Federal banking agency, the SEC, or the CFTC is the primary financial regulatory agency); (iii) the CFTC with respect to any entity for which it is the primary financial regulatory agency, as defined in section 2 of the Dodd-Frank Act; and (iv) the SEC with respect to any entity for which it is the primary financial regulatory agency, as defined in section 2 of the Dodd-Frank Act. See id.

⁹ See 12 U.S.C. 1851(b)(2)(B)(ii). The Secretary of the Treasury, as Chairperson of the Council, is responsible for coordinating the Agencies' rulemakings under section 13 of the BHC Act. See id.

¹⁰ See id. at 1851(b)(2)(A).

¹¹ See id. at 1851(c)(1).

¹² See id. at 1851(c)(6).

¹³ See Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 FR 8265 (Feb. 14, 2011).

¹⁴ See id. (citing 156 Cong. Rec. S5898 (daily ed. July 15, 2010) (statement of Sen. Merkley)).

¹⁵ 12 U.S.C. 1851(a)(1)(A) and (B).

- Trading in certain government obligations;
- Underwriting and market making-related activities;
- Risk-mitigating hedging activity;
- Trading on behalf of customers;
- Investments in Small Business Investment Companies (“SBICs”) and public interest investments;
- Trading for the general account of insurance companies;
- Organizing and offering a covered fund (including limited investments in such funds);
- Foreign trading by non-U.S. banking entities; and
- Foreign covered fund activities by non-U.S. banking entities.¹⁶

For purposes of this Supplementary Information, trading activities subject to section 13 of the BHC Act, including those permitted under a relevant exemption, are sometimes referred to as “covered trading activities.” Similarly, activities and investments with respect to a covered fund that are subject to section 13 of the BHC Act, including those permitted under a relevant exemption, are sometimes referred to as “covered fund activities or investments.”

Additionally, section 13 of the BHC Act permits the Agencies to grant, by rule, other exemptions from the prohibitions on proprietary trading and acquiring or retaining an ownership interest in, or acting as sponsor to, a covered fund if the Agencies determine that the exemption would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.¹⁷ Furthermore, under the statute, no banking entity may engage in a permitted activity if that activity would (i) involve or result in a material conflict of interest or material exposure of the banking entity to high-risk assets or high-risk trading strategies, or (ii) pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.¹⁸

Section 13(f) of the BHC Act separately prohibits a banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a covered fund, and any affiliate of such a banking entity, from entering into any transaction with the fund, or any other covered fund controlled by such fund, that would be a “covered transaction” as defined in section

¹⁶ See *id.* at 1851(d)(1). As described in greater detail in Part III.B.4 of this Supplementary Information, the proposed rule applies some of these statutory exemptions only to the proprietary trading prohibition or the covered fund prohibitions and restrictions, but not both, where it appears either by plain language or by implication that the exemption was intended only to apply to one or the other.

¹⁷ *Id.* at 1851(d)(1)(J).

¹⁸ See *id.* at 1851(d)(2).

23A of the Federal Reserve Act (“FR Act”),¹⁹ as if such banking entity or affiliate were a member bank and the covered fund were an affiliate thereof, subject to certain exceptions.²⁰ Section 13(f) also provides that a banking entity may enter into certain prime brokerage transactions with any covered fund in which a covered fund managed, sponsored, or advised by the banking entity has taken an equity, partnership, or other ownership interest, but any such transaction (and any other permitted transaction with such funds) must be on market terms in accordance with the provisions of section 23B of the FR Act.²¹

Section 13 of the BHC Act does not prohibit a nonbank financial company supervised by the Board from engaging in proprietary trading, or from having the types of ownership interests in or relationships with a covered fund that a banking entity is prohibited or restricted from having under section 13 of the BHC Act. However, section 13 of the BHC Act provides for the Board or other appropriate Agency to impose additional capital charges, quantitative limits, or other restrictions on a nonbank financial company supervised by the Board or their subsidiaries and affiliates that are engaged in such activities or maintain such relationships.²²

II. Overview of Proposed Rule.

A. General Approach.

In formulating the proposed rule, the Agencies have attempted to reflect the structure of section 13 of the BHC Act, which is to prohibit a banking entity from engaging in proprietary trading or acquiring or retaining an ownership interest in, or having certain relationships with, a covered fund, while permitting such entities to continue to provide client-oriented financial services.²³ However, the delineation of what constitutes a prohibited or permitted activity under section 13 of the BHC Act often involves subtle distinctions that are difficult both to describe comprehensively within regulation and to evaluate in practice. The Agencies appreciate that while it is crucial that rules under section 13 of the BHC Act clearly define and implement its requirements, any rule must also preserve the ability of a banking entity to continue to structure its businesses and manage its risks in a safe and sound manner, as well as to effectively deliver to its clients the types of financial services that section 13 expressly protects and permits. These client-oriented financial services, which include underwriting, market making, and traditional asset management services, are important to the U.S. financial markets and the participants in those markets, and the Agencies have endeavored to develop a proposed rule that does not unduly constrain banking entities in their efforts to safely provide such services. At the same time, providing appropriate latitude to banking entities to provide such client-oriented services

¹⁹ See 12 U.S.C. 371c.

²⁰ 12 U.S.C. 1851(f).

²¹ 12 U.S.C. 371c-1.

²² See 12 U.S.C. 1851(a)(2), (d)(4).

²³ See, e.g., 156 Cong. Rec. S5889 (daily ed. July 15, 2010) (statement of Sen. Hagan indicating that section 13 of the BHC Act permits a certain level of traditional asset management business, including the ability to sponsor and offer hedge fund and private equity funds). Id. at S5894 (daily ed. July 15, 2010) (statement of Sen. Merkley, noting that section 13 of the BHC Act, while broadly prohibiting certain activities, nevertheless permits certain activities that are, in fact, safe, client-oriented financial services).

need not and should not conflict with clear, robust, and effective implementation of the statute's prohibitions and restrictions.

In light of these larger challenges and goals, the Agencies' proposal takes a multi-faceted approach to implementing section 13 of the BHC Act. In particular, the proposed rule includes a framework that: (i) clearly describes the key characteristics of both prohibited and permitted activities; (ii) requires banking entities to establish a comprehensive programmatic compliance regime designed to ensure compliance with the requirements of the statute and rule in a way that takes into account and reflects the unique nature of a banking entity's businesses; and (iii) with respect to proprietary trading, requires certain banking entities to calculate and report meaningful quantitative data that will assist both banking entities and the Agencies in identifying particular activity that warrants additional scrutiny to distinguish prohibited proprietary trading from otherwise permissible activities. This multi-faceted approach, which is consistent with the implementation and supervisory framework recommended in the Council study, is intended to strike an appropriate balance between accommodating prudent risk management and the continued provision of client-oriented financial services by banking entities while ensuring that such entities do not engage in prohibited proprietary trading or restricted covered fund activities or investments.

In addition, and consistent with the statutory requirement that the Agencies' rules under section 13 of the BHC Act be, to the extent possible, comparable and provide for consistent application and implementation, the Agencies have proposed a common rule and appendices. This uniform approach to implementation is intended to provide the maximum degree of clarity to banking entities and market participants and ensure that section 13's prohibitions and restrictions are applied consistently across different types of regulated entities.²⁴

As a matter of structure, the proposed rule is generally divided into four subparts and contains three appendices, as follows:

- Subpart A of the proposed rule describes the authority, scope, purpose, and relationship to other authorities of the rule and defines terms used commonly throughout the rule;
- Subpart B of the proposed rule prohibits proprietary trading, defines terms relevant to covered trading activity, establishes exemptions from the prohibition on proprietary trading and limitations on those exemptions, and requires certain banking entities to report quantitative measurements with respect to their trading activities;
- Subpart C of the proposed rule prohibits or restricts acquiring or retaining an ownership interest in, and certain relationships with, a covered fund, defines terms relevant to covered fund activities and investments, as well as establishes exemptions from the restrictions on covered fund activities and investments and limitations on those exemptions;

²⁴ Under this uniform approach, each Agency is proposing the same rule provisions under section 13 of the BHC Act. Each Agency's proposed rule would apply only to banking entities for which the Agency has regulatory authority under section 13(b)(2)(B) of the BHC Act.

- Subpart D of the proposed rule generally requires banking entities to establish an enhanced compliance program regarding compliance with section 13 of the BHC Act and the proposed rule, including written policies and procedures, internal controls, a management framework, independent testing of the compliance program, training, and recordkeeping;
- Appendix A of the proposed rule details the quantitative measurements that certain banking entities may be required to compute and report with respect to their trading activities;²⁵
- Appendix B of the proposed rule provides commentary regarding the factors the Agencies propose to use to help distinguish permitted market making-related activities from prohibited proprietary trading; and
- Appendix C of the proposed rule details the minimum requirements and standards that certain banking entities must meet with respect to their compliance program, as required under subpart D.²⁶

In addition, the Board's proposed rule also contains a subpart E, to which the provisions of the Board's Conformance Rule under section 13 of the BHC Act will be recodified from their current location in the Board's Regulation Y.

B. Proprietary Trading Restrictions.

Subpart B of the proposed rule implements the statutory prohibition on proprietary trading and the various exemptions to this prohibition included in the statute. Section __.3 of the proposed rule contains the core prohibition on proprietary trading and defines a number of related terms, including "proprietary trading" and "trading account." The proposed rule's definition of proprietary trading generally parallels the statutory definition, and includes engaging as principal for the trading account of a banking entity in any transaction to purchase or sell certain types of financial positions.²⁷

²⁵ A banking entity must comply with proposed Appendix A's reporting and recordkeeping requirements only if it has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than \$1 billion.

²⁶ In particular, a banking entity must comply with the minimum standards specified in Appendix C of the proposed rule (i) with respect to its covered trading activities, if it engages in any covered trading activities and has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, (X) is equal to or greater than \$1 billion or (Y) equals 10 percent or more of its total assets; and (ii) with respect to its covered fund activities and investments, if it engages in any covered fund activities and investments and either (X) has, together with its affiliates and subsidiaries, aggregate investments in covered funds the average value of which is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than \$1 billion or (Y) sponsors and advises, together with its affiliates and subsidiaries, covered funds the average total assets of which are, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than \$1 billion.

²⁷ See proposed rule § __.3(b)(1).

The proposed rule's definition of trading account generally parallels the statutory definition, and provides further guidance regarding the circumstances in which a position will be considered to have been taken principally for the purpose of short-term resale or benefiting from actual or expected short-term price movements, recognizing the importance of providing as much clarity as possible regarding this term, which ultimately defines the scope of accounts subject to the prohibition on proprietary trading.²⁸ In particular, the proposed definition of trading account identifies three classes of positions that would cause an account to be a trading account. First, the definition includes positions taken principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position.²⁹ As described in this notice, this language is substantially similar to language for a "trading position" used in the Federal banking agencies' current market risk capital rules, as proposed to be revised ("Market Risk Capital Rules"),³⁰ and the Agencies propose to interpret this language in a similar manner. Second, with respect to a banking entity subject to the Federal banking agencies' Market Risk Capital Rules, the definition includes all positions in financial instruments subject to the prohibition on proprietary trading that are treated as "covered positions" under those capital rules, other than certain foreign exchange and commodities positions. Third, the definition includes all positions acquired or taken by certain registered securities and derivatives dealers (or, in the case of financial institutions³¹ that are government securities dealers, that have filed notice with an appropriate regulatory agency) in connection with their activities that require such registration or notice.³² The definition of trading account also contains clarifying exclusions for certain positions that do not appear to involve the requisite short-term trading intent, such as positions arising under certain repurchase and reverse repurchase arrangements or securities lending transactions, positions acquired or taken for bona fide liquidity management purposes, and certain positions of derivatives clearing organizations or clearing agencies.³³

Section __.3 of the proposed rule also defines a number of other relevant terms, including the term "covered financial position." This term is used to define the scope of financial instruments subject to the prohibition on proprietary trading. Consistent with the statutory language, such covered financial positions include positions (including long, short, synthetic and other positions) in securities, derivatives, commodity futures, and options on such instruments, but do not include positions in loans, spot foreign exchange or spot commodities.³⁴

²⁸ See proposed rule § __.3(b)(2).

²⁹ See proposed rule § __.3(b)(2)(i)(A).

³⁰ See 76 FR 1890 (Jan. 11, 2011).

³¹ In the context of regulation of government securities dealers under the Securities Exchange Act of 1934 ("Exchange Act"), the term "financial institution" as defined in section 3(a)(46) of the Exchange Act includes a bank (as defined in section 3(a)(36) of the Exchange Act) and a foreign bank (as defined in the International Banking Act of 1978). See 15 U.S.C. 78c(a)(46).

³² See proposed rule § __.3(b)(2)(i)(B).

³³ See proposed rule § __.3(b)(2)(iii).

³⁴ See proposed rule § __.3(b)(3).

Section __.4 of the proposed rule implements the statutory exemptions for underwriting and market making-related activities. For each of these permitted activities, the proposed rule provides a number of requirements that must be met in order for a banking entity to rely on the applicable exemption. These requirements are generally designed to ensure that the activities, revenues and other characteristics of the banking entity's trading activity are consistent with underwriting and market making-related activities, respectively, and not prohibited proprietary trading.³⁵ These requirements are intended to support and augment other parts of the proposed rule's approach to implementing the prohibition on proprietary trading, including the compliance program requirement and the reporting of quantitative measurements, in order to assist banking entities and the Agencies in identifying prohibited trading activities that may be conducted in the context of, or mischaracterized as, permitted underwriting or market making-related activities.

Section __.5 of the proposed rule implements the statutory exemption for risk-mitigating hedging. As with the underwriting and market-making exemptions, proposed § __.5 contains a number of requirements that must be met in order for a banking entity to rely on the exemption. These requirements are generally designed to ensure that the banking entity's trading activity is truly risk-mitigating hedging in purpose and effect.³⁶ Proposed § __.5 also requires banking entities to document, at the time the transaction is executed the hedging rationale for certain transactions that present heightened compliance risks.³⁷ As with the exemptions for underwriting and market making-related activity, these requirements form part of a broader implementation approach that also includes the compliance program requirement and the reporting of quantitative measurements.

Section __.6 of the proposed rule implements statutory exemptions for trading in certain government obligations, trading on behalf of customers, trading by a regulated insurance company, and trading by certain foreign banking entities outside the United States. Section __.6(a) of the proposed rule describes the government obligations in which a banking entity may trade notwithstanding the prohibition on proprietary trading, which include U.S. government and agency obligations, obligations and other instruments of certain government sponsored entities, and State and municipal obligations.³⁸ Section __.6(b) of the proposed rule describes permitted trading on behalf of customers and identifies three categories of transactions that would qualify for the exemption.³⁹ These categories include: (i) transactions conducted by a banking entity as investment adviser, commodity trading advisor, trustee, or in a similar fiduciary capacity for the account of a customer where the customer, and not the banking entity, has beneficial ownership of the related positions; (ii) riskless principal transactions; and (iii) transactions conducted by a banking entity that is a regulated insurance company for the separate account of insurance policyholders, subject to certain conditions. Section __.6(c) of the proposed rule describes permitted trading by a regulated insurance company for its general account, and generally parallels the statutory language governing this exemption.⁴⁰ Finally, § __.6(d) of the proposed

³⁵ See proposed rule § __.4(a), (b).

³⁶ See proposed rule §§ __.5(b)(1), (2).

³⁷ See proposed rule § __.5(b)(3).

³⁸ See proposed rule § __.6(a).

³⁹ See proposed rule § __.6(b).

⁴⁰ See proposed rule § __.6(c).

rule describes permitted trading outside of the United States by a foreign banking entity.⁴¹ The proposed exemption clarifies when a foreign banking entity will be considered to engage in such trading pursuant to sections 4(c)(9) or 4(c)(13) of the BHC Act, as required by the statute, including with respect to a foreign banking entity not currently subject to section 4 of the BHC Act. The exemption also clarifies when trading will be considered to have occurred solely outside of the United States, as required by the statute, and provides a number of specific criteria for determining whether that standard is met.

Section __.7 of the proposed rule requires certain banking entities with significant covered trading activities to comply with the reporting and recordkeeping requirements specified in Appendix A of the proposed rule. In addition, § __.7 requires that a banking entity comply with the recordkeeping requirements in § __.20 of the proposed rule, including, where applicable, the recordkeeping requirements in Appendix C of the proposed rule. Section __.7 of the proposed rule also requires a banking entity to comply with any other reporting or recordkeeping requirements that an Agency may impose to evaluate the banking entity's compliance with the proposed rule.⁴² Proposed Appendix A requires those banking entities with significant covered trading activities to furnish periodic reports to the relevant Agency regarding a variety of quantitative measurements of its covered trading activities and maintain records documenting the preparation and content of these reports. These proposed reporting and recordkeeping requirements vary depending on the scope and size of covered trading activities, and a banking entity must comply with proposed Appendix A's reporting and recordkeeping requirements only if it has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than \$1 billion. These thresholds are designed to reduce the burden on smaller, less complex banking entities, which generally engage in limited market-making and other trading activities. Other provisions of the proposal, and in particular the compliance program requirement in § __.20 of the proposed rule, are likely to be less burdensome and equally effective methods for ensuring compliance with section 13 of the BHC Act by smaller, less complex banking entities.

The quantitative measurements that must be furnished under the proposed rule are generally designed to reflect, and provide meaningful information regarding, certain characteristics of trading activities that appear to be particularly useful to help differentiate permitted market making-related activities from prohibited proprietary trading and to identify whether certain trading activities result in a material exposure to high-risk assets or high-risk trading strategies. In addition, proposed Appendix B contains a detailed commentary regarding identification of permitted market making-related activities and distinguishing such activities from trading activities that constitute prohibited proprietary trading.

As described in Part II.B.5 of the Supplementary Information below, the Agencies expect to utilize the conformance period provided in section 13(c)(2) of the BHC Act to further refine and finalize the reporting requirements, reflecting the substantial public comment, practical

⁴¹ See proposed rule § __.6(d).

⁴² See proposed rule § __.7.

experience, and revision that will likely be required to ensure appropriate, effective use of reported quantitative data in practice.

Section __.8 of the proposed rule prohibits a banking entity from relying on any exemption to the prohibition on proprietary trading if the permitted activity would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.⁴³ This section also defines material conflict of interest, high-risk asset, and high-risk trading strategy for these purposes.

C. Covered Fund Activities and Investments.

Subpart C of the proposed rule implements the statutory prohibition on, as principal, directly or indirectly, acquiring and retaining an ownership interest in, or having certain relationships with, a covered fund, as well as the various exemptions to this prohibition included in the statute. Section __.10 of the proposed rule contains the core prohibition on covered fund activities and investments and defines a number of related terms, including “covered fund” and “ownership interest.” The proposed rule’s definition of covered fund generally parallels the statutory definition of “hedge fund” and “private equity fund,” and explains the universe of entities that would be considered a “covered fund” (including those entities determined by the Agencies to be “such similar funds”) and, thus, subject to the general prohibition.⁴⁴

The definition of “ownership interest” provides further guidance regarding the types of interests that would be considered to be an ownership interest in a covered fund.⁴⁵ As described in this Supplementary Information, these interests may take various forms. The definition of ownership interest also explicitly excludes from the definition “carried interest” whereby a banking entity may share in the profits of the covered fund solely as performance compensation for services provided to the covered fund by the banking entity (or an affiliate, subsidiary, or employee thereof).⁴⁶

Section __.10 of the proposed rule also defines a number of other relevant terms, including the terms “prime brokerage transaction,” “sponsor,” and “trustee.”

Section __.11 of the proposed rule implements the exemption for organizing and offering a covered fund provided for under section 13(d)(1)(G) of the BHC Act. Section __.11(a) of the proposed rule outlines the conditions that must be met in order for a banking entity to organize and offer a covered fund under this authority. These requirements are contained in the statute and are intended to allow a banking entity to engage in certain traditional asset management and

⁴³ See proposed rule § __.8.

⁴⁴ See proposed rule § __.10(b)(1).

⁴⁵ See proposed rule § __.10(b)(3).

⁴⁶ See proposed rule § __.10(b)(3)(ii).

advisory businesses in compliance with section 13 of the BHC Act.⁴⁷ The requirements are discussed in detail in Part III.C.2 of this Supplementary Information.

Section __.12 of the proposed rule permits a banking entity to acquire and retain, as an investment in a covered fund, an ownership interest in a covered fund that the banking entity organizes and offers under § __.11.⁴⁸ This section implements section 13(d)(4) of the BHC Act and related provisions. Section 13(d)(4) of the BHC Act permits a banking entity to make an investment in a covered fund that the banking entity organizes and offers pursuant to section 13(d)(1)(G), or for which it acts as sponsor, for the purposes of (i) establishing the covered fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or (ii) making a *de minimis* investment in the covered fund in compliance with applicable requirements. Section __.12 of the proposed rule implements this authority and related limitations, including limitations regarding the amount and value of any individual per-fund investment and the aggregate value of all such permitted investments.⁴⁹ Proposed § __.12 also clarifies how a banking entity must calculate its compliance with these investment limitations (including by deducting such investments from applicable capital, as relevant), as well as sets forth how a banking entity may request an extension of the period of time within which it must conform an investment in a single covered fund.⁵⁰

Section __.13 of the proposed rule implements the statutory exemptions described in sections 13(d)(1)(C), (E), and (I) of the BHC Act that permit a banking entity: (i) to acquire and retain an ownership interest in, or act as sponsor to, one or more SBICs, a public welfare investment, or certain qualified rehabilitation expenditures; (ii) to acquire and retain an ownership interest in a covered fund as a risk-mitigating hedging activity; and (iii) in the case of a non-U.S. banking entity, to acquire and retain an ownership interest in, or act as sponsor to, a foreign covered fund.⁵¹ Section __.13(a) of the proposed rule permits a banking entity to acquire and retain an ownership interest in, or act as sponsor to, an SBIC or certain public interest investments, without limitation as to the amount of ownership interests it may own, hold, or control with the power to vote.⁵²

Section __.13(b) of the proposed rule permits a banking entity to use an ownership interest in a covered fund to hedge, but only with respect to individual or aggregated obligations or liabilities of a banking entity that arise from: (i) the banking entity acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the customer's exposure to the profits and losses of the covered fund (similar to acting as a "riskless principal"); or (ii) a compensation arrangement with an employee of the banking entity that directly provides investment advisory or other services to that fund.⁵³ Additionally, § __.13(b) of the proposed

⁴⁷ See 156 Cong. Rec. S5889 (daily ed. July 15, 2010) (statement of Sen. Hagan).

⁴⁸ See proposed rule § __.12.

⁴⁹ See proposed rule § __.12(a)(2).

⁵⁰ See proposed rule §§ __.12(b), (c), and (d).

⁵¹ See proposed rule § __.13(a) – (c).

⁵² See proposed rule § __.13(a).

⁵³ See proposed rule § __.13(b)(1).

rule requires that the hedge represent a substantially similar offsetting exposure to the same covered fund and in the same amount of ownership interest in the covered fund arising out of the transaction that the acquisition or retention of an ownership interest in the covered fund is intended to hedge or otherwise mitigate.⁵⁴ Proposed § __.13(b) also requires a banking entity to document, at the time the transaction is executed, the hedging rationale for all hedging transactions involving an ownership interest in a covered fund.⁵⁵

Section __.13(c) of the proposed rule implements section 13(d)(1)(I) of the BHC Act and permits certain foreign banking entities to acquire or retain an ownership interest in, or to act as sponsor to, a covered fund so long as such activity occurs solely outside of the United States and the entity meets the requirements of sections 4(c)(9) or 4(c)(13) of the BHC Act. This statutory exemption limits the extraterritorial application of the statutory restrictions on covered fund activities and investments to foreign firms that, in the course of operating outside of the United States, engage in activities permitted under relevant foreign law outside of the United States, while preserving national treatment and competitive equality among U.S. and foreign firms within the United States.⁵⁶ The proposed rule defines both the type of foreign banking entities that are eligible for the exemption and the circumstances in which covered fund activities or investments by such an entity will be considered to have occurred solely outside of the United States (including clarifying when an ownership interest will be considered to have been offered for sale or sold to a resident of the United States). Section __.13(d) of the proposed rule also implements in part the rule of construction contained in section 13(g)(2) of the BHC Act, which permits the sale and securitization of loans.⁵⁷ Proposed § __.13(d) clarifies that a banking entity may acquire and retain an ownership interest in, or act as sponsor to, a covered fund that is an issuer of asset-backed securities, the assets or holdings of which are solely comprised of: (i) loans; (ii) contractual rights or assets directly arising from those loans supporting the asset-backed securities; and (iii) a limited amount of interest rate or foreign exchange derivatives that materially relate to such loans and that are used for hedging purposes with respect to the securitization structure.⁵⁸ The authority contained in this section of the proposed rule would therefore allow a banking entity to acquire and retain an ownership interest in a loan securitization vehicle (which would be a covered fund for purposes of section 13(h)(2) of the BHC Act and the proposed rule) that the banking entity organizes and offers, or acts as sponsor to, in excess of the three percent limits specified in section 13(d)(4) of the BHC Act and § __.12 of the proposed rule.

⁵⁴ See proposed rule §§ __.13(b)(2)(ii)(C) and (D).

⁵⁵ See proposed rule § __.13(b)(3).

⁵⁶ See 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

⁵⁷ See 12 U.S.C. 1851(g)(2).

⁵⁸ See proposed rule § __.13(d).

Section __.14 of the proposed rule implements section 13(d)(1)(J) of the BHC Act⁵⁹ and permits a banking entity to engage in any covered fund 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.⁶⁰ The Agencies have proposed to permit three activities at this time under this authority. These activities involve acquiring and retaining an ownership interest in, or acting as sponsor to, certain bank owned life insurance (“BOLI”) separate accounts, investments in and sponsoring of certain asset-backed securitizations, and investments in and sponsoring of certain entities that rely on the exclusion from the definition of investment company in section 3(c)(1) and/or 3(c)(7) of the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*) (“Investment Company Act”) but that are, in fact, common corporate organizational vehicles.⁶¹ Additionally, the Agencies have proposed to permit a banking entity to acquire and retain an ownership interest in, or act as sponsor to, a covered fund, if such acquisition or retention is done (i) in the ordinary course of collecting a debt previously contracted, or (ii) pursuant to and in compliance with the Conformance or Extended Transition Periods implemented under section 13(c)(6) of the BHC Act.⁶²

Section __.15 of the proposed rule, which implements section 13(e)(1) of the BHC Act,⁶³ requires a banking entity engaged in covered fund activities and investments to comply with (i) the internal controls, reporting, and recordkeeping requirements required under § __.20 and Appendix C of the proposed rule, as applicable and (ii) such other reporting and recordkeeping requirements as the relevant supervisory Agency may deem necessary to appropriately evaluate the banking entity’s compliance with subpart C.⁶⁴

Section __.16 of the proposed rule implements section 13(f) of the BHC Act and generally prohibits a banking entity from entering into certain transactions with a covered fund that would be a covered transaction as defined in section 23A of the FR Act.⁶⁵ Section __.16(a)(2) of the proposed rule clarifies that, for reasons explained in part III.C.7 of this Supplementary Information, certain transactions between a banking entity and a covered fund remain permissible. Section __.16(b) of the proposed rule implements the statute’s requirement that any transaction permitted under section 13(f) of the BHC Act (including a prime brokerage transaction) between the banking entity and a covered fund is subject to section 23B of the FR Act,⁶⁶ which, in general, requires that the transaction be on market terms or on terms at least as

⁵⁹ Section 13(d)(1)(J) of the BHC Act provides the Agencies discretion to determine that activities not specifically identified by sections 13(d)(1)(A) – (I) of the BHC Act are also exempted from the general prohibitions contained in section 13(a) of that Act, and are thus permitted activities. In order to make such a determination, the Agencies must find that such activity or activities promote and protect the safety and soundness of banking entities, as well as promote and protect the financial stability of the United States. See 12 U.S.C. 1851(d)(1)(J).

⁶⁰ See 12 U.S.C. 1851(d)(1)(J).

⁶¹ See proposed rule § __.13(a)(1) – (2).

⁶² See proposed rule at § __.14(b).

⁶³ Section 13(e)(1) of the BHC Act requires the Agencies to issue regulations regarding internal controls and recordkeeping to ensure compliance with section 13. See 12 U.S.C. 1851(e)(1).

⁶⁴ See proposed rule § __.15.

⁶⁵ See proposed rule § __.16.

⁶⁶ 12 U.S.C. 371c-1.

favorable to the banking entity as a comparable transaction by the banking entity with an unaffiliated third party.

Section __.17 of the proposed rule prohibits a banking entity from relying on any exemption to the prohibition on acquiring and retaining an ownership interest in, acting as sponsor to, or having certain relationships with, a covered fund, if the permitted activity or investment would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.⁶⁷ This section also defines material conflict of interest, high-risk asset, and high-risk trading strategy for these purposes.

D. Compliance Program Requirement.

Subpart D of the proposed rule requires a banking entity engaged in covered trading activities or covered fund activities to develop and implement a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on covered trading activities and covered fund activities and investments set forth in section 13 of the BHC Act and the proposed rule.⁶⁸ Section __.20(b) of the proposed rule specifies six elements that each compliance program established under subpart D must, at a minimum, include:

- Internal written policies and procedures reasonably designed to document, describe, and monitor the covered trading activities and covered fund activities and investments of the banking entity to ensure that such activities comply with section 13 of the BHC Act and the proposed rule;
- A system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with section 13 of the BHC Act and the proposed rule in the banking entity's covered trading and covered fund activities and to prevent the occurrence of activities that are prohibited by section 13 of the BHC Act and the proposed rule;
- A management framework that clearly delineates responsibility and accountability for compliance with section 13 of the BHC Act and the proposed rule;
- Independent testing for the effectiveness of the compliance program, conducted by qualified banking entity personnel or a qualified outside party;
- Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and

⁶⁷ See proposed rule § __.17.

⁶⁸ See proposed rule § __.20. If a banking entity does not engage in covered trading activities and/or covered fund activities and investments, it need only ensure that its existing compliance policies and procedures include measures that are designed to prevent the banking entity from becoming engaged in such activities and making such investments, and which require the banking entity to develop and provide for the required compliance program prior to engaging in such activities or making such investments.

- Making and keeping records sufficient to demonstrate compliance with section 13 of the BHC Act and the proposed rule, which a banking entity must promptly provide to the relevant Agency upon request and retain for a period of no less than 5 years.

For a banking entity with significant covered trading activities or covered fund activities and investments, the compliance program must also meet a number of minimum standards that are specified in Appendix C of the proposed rule.⁶⁹ The application of detailed minimum standards for these types of banking entities is intended to reflect the heightened compliance risks of large covered trading activities and covered fund activities and investments and to provide clear, specific guidance to such banking entities regarding the compliance measures that would be required for purposes of the proposed rule. For banking entities with smaller, less complex covered trading activities and covered fund activities and investments, these detailed minimum standards are not applicable, though the Agencies expect that such smaller entities will consider these minimum standards as guidance in designing an appropriate compliance program.

E. Conformance Provisions.

Subpart E of the Board's proposed rule incorporates, with minor technical and conforming edits, the final rule which the Board, after soliciting and considering public comment, issued regarding the conformance periods for entities engaged in prohibited proprietary trading or covered fund activities and investments.⁷⁰ That rule implements the conformance period and extended transition period, as applicable, during which a banking entity and nonbank financial company supervised by the Board must bring its activities, investments and relationships into compliance with the prohibitions and restrictions on proprietary trading and acquiring an ownership interest in, or having certain relationships with, a covered fund.

F. Treatment of Smaller, Less-Complex Banking Entities.

In formulating the proposed rule, the Agencies have carefully considered and taken into account the potential impact of the proposed rule on small banking entities and banking entities that engage in little or no covered trading activities or covered fund activities and investments, including the burden and cost that might be associated with such banking entities' compliance with the proposed rule. In particular, the Agencies have proposed to reduce the effect of the proposed rule on such banking entities by limiting the application of certain requirements, such as the reporting and recordkeeping requirements of § __.7 and Appendix A of the proposed rule and the compliance program requirements contained in subpart D and Appendix C of the

⁶⁹ A banking entity must comply with the minimum standards specified in Appendix C of the proposed rule (i) with respect to its covered trading activities, if it engages in any covered trading activities and has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, (X) is equal to or greater than \$1 billion or (Y) equals 10 percent or more of its total assets; and (ii) with respect to its covered fund activities and investment, if it engages in any covered fund activities and investments and either (X) has, together with its affiliates and subsidiaries, aggregate investments in covered funds the average value of which is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than \$1 billion or (Y) sponsors and advises, together with its affiliates and subsidiaries, covered funds the average total assets of which are, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than \$1 billion.

⁷⁰ See 76 FR 8265 (Feb. 14, 2011).

proposed rule, to those banking entities that engage in little or no covered trading activities or covered fund activities and investments. The Agencies have also requested comment (i) throughout this Supplementary Information on a number of questions related to the costs and burdens associated with particular aspects of the proposal, as well as (ii) in Part VII.B of this Supplementary Information on any significant alternatives that would minimize the impact of the proposal on small banking entities.

G. Application of Section 13 of the BHC Act to Securitization Vehicles or Issuers of Asset-Backed Securities.

Many issuers of asset-backed securities may be included within the definition of covered fund since they would be an investment company but for the exclusions contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act.⁷¹ If an issuer of asset-backed securities is considered to be a covered fund, then a banking entity would not be permitted to acquire or retain any ownership interest issued by such issuer except as otherwise permitted under section 13 of the BHC Act and the proposed rule.⁷² Separately, issuers of asset-backed securities may be included within the definition of banking entity, as noted in Part III.A.2 of this Supplementary information. Although the proposed definition of banking entity would not include any entity that is a covered fund, an issuer of asset-backed securities that is both (i) an affiliate or subsidiary of a banking entity,⁷³ and (ii) does not rely on an exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act, would be a banking entity and thus subject to the requirements of section 13 of the BHC Act and the proposed rule, including: (i) the prohibition on proprietary trading; (ii) limitations on investments in and relationships with a covered fund; (iii) the establishment and implementation of a compliance program as required under the proposed rule; and (iv) recordkeeping and reporting requirements. Given the breadth of the definition of “affiliate,” these requirements may apply to a significant portion of the outstanding securitization market, including issuers of asset-backed securities that rely on rule 3a-7 or section 3(c)(5) of the Investment Company Act.

⁷¹ For purposes of the proposed rule, any securitization entity that meets the requirements for an exclusion under Rule 3a-7 or section 3(c)(5) of the Investment Company Act, or any other exclusion or exemption from the definition of “investment company” under the Investment Company Act (other than sections 3(c)(1) or 3(c)(7) of the Investment Company Act), would not be a covered fund under the proposed definition. Additionally, an issuer of asset-backed securities that is subject to legal documents mandating compliance with the conditions of section 3(c)(1) or 3(c)(7) of the Investment Company Act would not be a covered fund if such issuer also can satisfy all the conditions of an alternative exclusion or exemption for which it is eligible.

⁷² For example, under the proposed rule, a banking entity would be able to acquire or retain an interest or security of an issuer of asset-backed securities that is a covered fund if: (i) the interest or security of the issuer does not qualify as an “ownership interest” under § __.10(b)(3) of the proposed rule; (ii) the issuer of asset-backed securities is comprised solely of loans, contractual rights or assets directly arising from those loans, and certain specified interest rate or foreign exchange derivatives used for hedging purposes, as permitted under § __.13(d) or __.14(a)(2)(v) of the proposed rule; (iii) the banking entity is a “securitizer” or “originator” and acquires and retains such interest in compliance with the minimum requirements of section 15G of the Exchange Act and any implementing regulations issued thereunder, as provided under § __.14(a)(2)(iii) of the proposed rule; or (v) the banking entity organizes and offers the issuer and the ownership interest is a permitted investment under § __.12 of the proposed rule. The circumstances where a banking entity may acquire or retain an ownership interest in a covered fund are discussed in detail in Part III.C of this Supplemental Information.

⁷³ The definitions of “affiliate” and “subsidiary” are discussed in detail in Part III.A.2 of this Supplemental Information.

In recognition of these concerns, the Agencies have requested comment throughout this Supplementary Information on the potential effects of section 13 of the BHC Act and the proposed rule on the securitization industry and issuers of asset-backed securities.

III. Section by Section Summary of Proposed Rule.

A. Subpart A – Authority and Definitions.

1. Section __.1: Authority, purpose, scope, and relationship to other authorities.

a. Authority and scope.

Section __.1 of the proposed rule describes the authority under which each Agency is issuing the proposed rule, the purpose of the proposed rule, and the banking entities to which each Agency's rule applies. In addition, § __.1(d) of the proposed rule implements section 13(g)(1) of the BHC Act, which provides that the prohibitions and restrictions of section 13 apply to the activities of a banking entity regardless of whether such activities are authorized for a banking entity under other applicable provisions of law.⁷⁴

b. Effective date.

Section 13(c)(1) of the BHC Act provides that section 13 shall take effect on the earlier of (i) 12 months after the date of issuance of final rules implementing that section, or (ii) 2 years after the date of enactment of section 13, which is July 21, 2012.⁷⁵ Because the Agencies did not issue final rules implementing section 13 of the BHC Act by July 21, 2011, § __.1 of the proposed rule specifies that the effective date for its provisions will be July 21, 2012.

The Agencies note that the proposed effective date will impact not only the date on which the proposed rule's prohibitions and restrictions on proprietary trading and covered fund activities and investments go into effect (subject to the conformance period or extended transition period provided by section 13(c) of the BHC Act),⁷⁶ but also the date on which a banking entity must comply with (i) the reporting and recordkeeping requirements of § __.7 and Appendix A of the proposed rule and (ii) the compliance program mandate of § __.20 and Appendix C of the proposed rule. As proposed, § __.1 would require a banking entity subject to either the reporting and recordkeeping or compliance program requirements to begin complying with these requirements as of July 21, 2012.⁷⁷ With respect to the compliance program requirement of the proposed rule, § __.1 would require a banking entity to have developed and implemented the required program by the proposed effective date, though the Agencies note that prohibited activities and investments may not be fully conformed by that date. The Agencies expect a banking entity to fully conform all investments and activities to the requirements of the proposed rule as soon as practicable within the conformance periods provided in section 13 of

⁷⁴ See proposed rule § __.1(d).

⁷⁵ See 12 U.S.C. 1851(c)(1).

⁷⁶ See *id.* at 1851(c)(2) – (6).

⁷⁷ See proposed rule § __.1.

the BHC Act and the Board's rules thereunder, which define the conformance periods. With respect to the reporting and recordkeeping requirements of the proposed rule, § __.1 of the proposed rule would require a banking entity to begin furnishing these reports for all trading units or asset management units as of the effective date, though the quantitative measurements furnished for proprietary trading activities that are conducted in reliance on the authority provided by the conformance period would not be used to identify prohibited proprietary trading until such time as the relevant trading activities must be conformed.

The Agencies expect that a banking entity may need a period of time to prepare for effectiveness of the proposed rule and, in particular, to implement both the compliance program and the reporting and recordkeeping requirements provided under the proposed rule. Accordingly, in order to help assess the effects and impact of the proposed effective date and any alternative compliance dates, the Agencies request comment on the following questions:

Question [•]. Does the proposed effective date provide banking entities with sufficient time to prepare to comply with the prohibitions and restrictions on proprietary trading and covered fund activities and investments? If not, what other period of time is needed and why?

Question [•]. Does the proposed effective date provide banking entities with sufficient time to implement the proposal's compliance program requirement? If not, what are the impediments to implementing specific elements of the compliance program and what would be a more effective time period for implementing each element and why?

Question [•]. Does the proposed effective date provide banking entities sufficient time to implement the proposal's reporting and recordkeeping requirements? If not, what are the impediments to implementing specific elements of the proposed reporting and recordkeeping requirements and what would be a more effective time period for implementing each element and why?

2. Section __.2: Definitions.

Section __.2 of the proposed rule defines a variety of terms used throughout the proposed rule, including "banking entity," which defines the scope of entities to which the proposed rule applies. Consistent with the statutory definition of that term, § __.2(e) of the proposed rule provides that a "banking entity" includes: (i) any insured depository institution; (ii) any company that controls an insured depository institution; (iii) any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (12 U.S.C. 3106); and (iv) any affiliate or subsidiary of any of the foregoing.⁷⁸ In addition, in order to avoid application of section 13 of the BHC Act in a way that appears unintended by the statute and would create internal inconsistencies in the statutory scheme, the proposed rule also clarifies that the term "banking entity" does not include any affiliate or subsidiary of a banking entity, if that affiliate or subsidiary is (i) a covered fund, or (ii) any entity controlled by such a covered fund.⁷⁹

⁷⁸ See proposed rule § __.2(e). Sections __.2(a) and (bb) of the proposed rule clarify that the terms "affiliate" and "subsidiary" have the same meaning as in sections 2(d) and (k) of the BHC Act (12 U.S.C. 1841(d) and (k)).

⁷⁹ The Agencies note that since the proposed rule implements section 13 of the BHC Act, it incorporates that Act's definition of "affiliate" and "subsidiary." See proposed rule §§ __.2(a) and (bb). The terms affiliate and subsidiary are generally defined in section 2 of the BHC Act according to whether such entity controls or is controlled by

This clarification is proposed because the definition of “affiliate” and “subsidiary” under the BHC Act is broad, and could include a covered fund that a banking entity has permissibly sponsored or made an investment in because, for example, the banking entity acts as general partner or managing member of the covered fund as part of its permitted sponsorship activities.⁸⁰ If such a covered fund were considered a “banking entity” for purposes of the proposed rule, the fund itself would become subject to all of the restrictions and limitations of section 13 of the BHC Act and the proposed rule, which would be inconsistent with the purpose and intent of the statute. For example, such a covered fund would then generally be prohibited from investing in other covered funds, notwithstanding the fact that section 13(f)(3) of the BHC Act specifically contemplates such investments. Accordingly, the proposed rule would exclude from the definition of banking entity any fund that a banking entity may invest in or sponsor as permitted by the proposed rule.

An entity such as a mutual fund would generally not be a subsidiary or affiliate of a banking entity under this definition if the banking entity only provides advisory or administrative services to, has certain limited investments in, or organizes, sponsors, and manages a mutual fund (which includes a registered investment company) in accordance with BHC Act rules.⁸¹

Section __.2(j) of the proposed rule defines the term “covered banking entity,” which is used in each Agency’s proposed rule to describe the specific types of banking entities to which that Agency’s rule applies. In addition, a number of other definitions contained in § __.2 are discussed in further detail below in connection with the separate sections of the proposed rule in which they are used.

The proposed rule also defines the terms “buy and purchase” and “sell and sale,” which are used throughout the proposed rule to describe the scope of transactions that are subject to subparts B and C of the proposed rule. These definitions are substantially similar to the definitions of the same terms under the Exchange Act, except that the proposed definitions provide additional clarity regarding the types of transactions that would be considered the purchase or sale of a commodity future or derivative or ownership interest in a covered fund.⁸² These definitions are purposefully broad in scope, and are intended to include a wide range of transaction types that would permit a banking entity to gain or eliminate, or increase or reduce, exposure to a covered financial position or ownership interest in a covered fund.

Request for comment.

The Agencies request comment on the proposed rule’s definition of “banking entity.” In particular, the Agencies request comment on the following questions:

another relevant entity. See 12 U.S.C. 1841(d), (k). The concept of control under the proposed rule, in turn, is as defined in section 2 of the BHC Act and as implemented by the Board. See 12 U.S.C. 1841(a)(2); 12 CFR 225.2(e).

⁸⁰ Under section 2 of the BHC Act and the Board’s Regulation Y (12 CFR part 225), a banking entity acting as general partner or managing member of another company would be deemed to control that company and, as such, the company would be both an “affiliate” and “subsidiary” of the banking entity for purposes of the BHC Act. See 12 U.S.C. 1841(d), (k).

⁸¹ See, e.g., 12 U.S.C. 1483(c)(6), (c)(8), and (k); 12 CFR 225.28(b)(6), 225.86(b)(3).

⁸² See proposed rule §§ __.2(g), (v); 15 U.S.C. 78c(a)(13), (14).

Question [•]. Is the proposed rule's definition of banking entity effective? What alternative definitions might be more effective in light of the language and purpose of the statute?

Question [•]. Are there any entities that should not be included within the definition of banking entity since their inclusion would not be consistent with the language or purpose of the statute or could otherwise produce unintended results? Should a registered investment company be expressly excluded from the definition of banking entity? Why or why not?

Question [•]. Banking entities commonly structure their registered investment company relationships and investments such that the registered investment company is not considered an affiliate or subsidiary of the banking entity. Should a registered investment company be expressly excluded from the definition of banking entity? Why or why not? Are there circumstances in which such companies should be treated as banking entities subject to section 13 of the BHC Act? How many such companies would be covered by the proposed definition?

Question [•]. Under the proposed rule, would issuers of asset-backed securities be captured by the proposed definition of "banking entity"? If so, are issuers of asset-backed securities within certain asset classes particularly impacted? Are particular types of securitization vehicles (trusts, LLCs, etc.) more likely than others to be included in the definition of banking entity? Should issuers of asset-backed securities be excluded from the proposed definition of "banking entity," and if so, why? How would such an exclusion be consistent with the language and purpose of the statute?

Question [•]. What would be the potential impact of including existing issuers of asset-backed securities⁸³ in the proposed definition of "banking entity" on existing issuers of asset-backed securities and the securitization market generally? How many existing issuers of asset-backed securities might be included in the proposed definition of "banking entity"? Are there ways in which the proposed rule could be amended to mitigate or eliminate potential impact, if any, on existing asset-backed securities⁸⁴ without compromising the intent of the statute?

Question [•]. What would be the legal and economic impact to an issuer of asset-backed securities of being considered a "banking entity"? What additional costs would be incurred in the establishment and implementation of a compliance program related to the provisions of the proposed rule as required by § __.20 of the proposed rule (including Appendix C, where applicable)? Who would pay those additional costs?

Question [•]. If the ownership requirement under the proposed rule for credit risk retention (section 15G of the Exchange Act) combined with the control inherent in the position of servicer or investment manager means that more securitization vehicles would be considered affiliates of banking entities, would fewer banking entities be willing to (i) serve as the servicer or investment manager of securitization transactions and/or (ii) serve as the originator or

⁸³ For purposes of this Supplemental Information, "existing issuers of asset-backed securities" means issuers that issued asset-backed securities prior to the effective date of the proposed rule.

⁸⁴ For purposes of this Supplemental Information, "existing asset-backed securities" means asset-backed securities that were issued prior to the effective date of the proposed rule.

securitizer (as defined in section 15G of the Exchange Act) of securitization transactions? What other impact might the potential interplay between these rules have on future securitization transactions? Could there be other potential unintended consequences?

Question [•]. Are the proposed rule's definitions of buy and purchase and sale and sell appropriate? If not, what alternative definitions would be more appropriate? Should any other terms be defined? If so, are there existing definitions in other rules or regulations that could be used in this context? Why would the use of such other definitions be appropriate?

B. Subpart B – Proprietary Trading Restrictions.

1. Section __.3: Prohibition on proprietary trading.

Section __.3 of the proposed rule describes the scope of the prohibition on proprietary trading and defines a number of terms related to proprietary trading. The Agencies note that the definition of “proprietary trading” in the statute and under the proposed rule is broad. This definition must be viewed in light of the exemptions described later in the proposed rule, which reflect statutory provisions permitting a number of activities.

a. Prohibition on proprietary trading.

Section __.3(a) of the proposed rule implements section 13(a)(1)(A) of the BHC Act and prohibits a banking entity from engaging in proprietary trading unless otherwise permitted under §§ __.4 through __.6 of the proposed rule. Section __.3(b)(1) of the proposed rule defines proprietary trading in accordance with section 13(h)(4) of the BHC Act.⁸⁵ This definition is a key element of the proposal because, unless an activity covered by the definition is specifically permitted under one of the exemptions contained in §§ __.4 through __.6 of the proposed rule, a banking entity is prohibited from engaging in that activity. Specifically, the proposal largely restates the statutory definition of proprietary trading, defining that term to mean engaging in the purchase or sale of one or more covered financial positions as principal for the trading account of the banking entity.⁸⁶ The terms “trading account” and “covered financial position” are defined in §§ __.3(b)(2) and __.3(b)(3) of the proposed rule, respectively. The proposed definition of proprietary trading also clarifies that proprietary trading does not include acting as agent, broker, or custodian for an unaffiliated third party, because acting in these types of capacities does not involve trading as principal, which is one of the requisite aspects of the statutory definition.

b. “Trading account”.

i. Definition of “trading account”.

Section 13(h)(6) of the BHC Act defines the term “trading account” as “any account used for acquiring or taking positions in securities [or other enumerated instruments] principally for

⁸⁵ See proposed rule § __.3(b)(1).

⁸⁶ See 12 U.S.C. 1851(h)(4); see also proposed rule § __.3(b)(1). Although the statutory definition refers to the “purchase, sale, acquisition, or disposition of” covered financial positions, the proposed rule uses the simpler terms “purchase” and “sale,” which are defined broadly in §§ __.2(g) and (v) of the proposed rule.

the purpose of selling in the near-term (or otherwise with the intent to resell in order to profit from short-term price movements),” as well as any such other accounts that the Agencies by rule determine.⁸⁷ As an initial matter, the Agencies note that it is often difficult to clearly identify the purpose for which a position is acquired or taken and whether that purpose is short-term in nature, particularly since identification of that purpose generally depends on the intent with which the position is acquired or taken. Moreover, the statute does not define the terms “near-term” or “short-term” for these purposes.

In implementing the statutory definition of trading account, the proposed rule generally restates the statutory definition, with the addition of certain details intended to provide banking entities with greater clarity regarding the scope of positions that fall within the definition of trading account.⁸⁸ The proposed definition of trading account has three prongs. First, under the proposed rule, a trading account includes any account that is used by a banking entity to acquire or take one or more covered financial positions for the purpose of: (i) short-term resale; (ii) benefitting from actual or expected short-term price movements; (iii) realizing short-term arbitrage profits; or (iv) hedging one or more such positions.⁸⁹ Second, the proposed definition of trading account also includes any account used by a banking entity that is subject to the Market Risk Capital Rules to acquire or take one or more covered financial positions that are subject to those rules, other than certain foreign exchange and commodity positions.⁹⁰ Third, the proposed definition of trading account also includes any account used by a banking entity that is a securities dealer, swap dealer, or security-based swap dealer to acquire or take positions in connection with its dealing activities.⁹¹ To provide additional clarity and guidance regarding the trading account definition, the proposed rule also includes a rebuttable presumption that any account used to acquire or take a covered financial position that is held for sixty days or less is a trading account under the first prong, unless the banking entity can demonstrate that the position was not acquired principally for short-term trading purposes. The proposed definition also clarifies that no account will be a trading account to the extent that it is used to acquire or take certain positions under repurchase or reverse repurchase arrangements or securities lending transactions, positions for *bona fide* liquidity management purposes, or certain positions held by derivatives clearing organizations or clearing agencies. Each of the three definitional prongs is independent of the others – any one prong would, if met, cause the relevant account to fall within the definition of “trading account.”

The Agencies have drawn on existing rules, in particular the Market Risk Capital Rules and various securities and commodities laws, in identifying trading accounts and defining related terms in the proposal.

⁸⁷ See 12 U.S.C. 1851(h)(6).

⁸⁸ The Agencies note that the structure of the proposed definition, which defines a trading account by reference to the positions that the account is used to acquire or take, is consistent with the structure of the statutory language used in section 13(h)(6) of the BHC Act.

⁸⁹ See proposed rule § __.3(b)(2)(i)(A).

⁹⁰ See proposed rule § __.3(b)(2)(i)(B).

⁹¹ See proposed rule § __.3(b)(2)(i)(C).

ii. Positions acquired or taken for short-term trading purposes.

The first prong of the proposed trading account definition refers to positions that a banking entity acquires or takes principally for short-term purposes – that is, for one of the following enumerated purposes described in §§ __.3(b)(2)(i)(A)(1) through (4) of the proposed rule:

- Short-term resale;
- Benefitting from actual or expected short-term price movements;
- Realizing short-term arbitrage profits; or
- Hedging one or more such positions.

This prong reflects the statutory definition’s reference to positions acquired or taken “principally 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).”⁹²

Section __.3(b)(2)(i)(A)(1) of the proposed rule’s definition of trading account includes covered financial positions acquired or taken principally for the purpose of short-term resale.⁹³ This part of the trading account definition restates language contained in the statutory definition of trading account and describes one class of positions that are acquired or taken for short-term trading purposes.

Section __.3(b)(2)(i)(A)(2) of the proposed rule includes covered financial positions acquired or taken principally for the purpose of benefitting from actual or expected short-term price movements.⁹⁴ This part of the trading account definition does not require the resale of the position; rather, it requires only an intent to engage in any form of transaction on a short-term basis (including a transaction separate from, but related to, the initial acquisition of the position) for the purpose of benefitting from a short-term movement in the price of the underlying position. This part of the proposed definition would, for example, include a derivative or other position where the banking entity enters into (or intends to enter into) a subsequent transaction in the near-term to simply offset or “close out,” rather than sell, all or a portion of the risks of the initial position, in order to benefit from a price movement occurring between the acquisition of the underlying position and the subsequent offsetting transaction. Similarly, it would also include a derivative, commodity future, or other position that, regardless of the term of that position, is subject to the exchange of short-term variation margin through which the banking entity intends to benefit from short-term price movements. The proposed definition would also capture the acquisition of a debt instrument where the banking entity intends to enter into a short-term transaction to simply offset, rather than sell, the credit, interest rate and/or other material

⁹² See 12 U.S.C. 1851(h)(6); see also proposed rule § __.3(b)(2)(i).

⁹³ See proposed rule § __.3(b)(2)(i)(A)(1).

⁹⁴ See proposed rule § __.3(b)(2)(i)(A)(2).

risk elements of the initial position so as to benefit from a price movement occurring between acquisition of the underlying position and the subsequent offsetting transaction.

Section __.3(b)(2)(i)(A)(3) of the proposed rule's definition of trading account includes covered financial positions acquired or taken principally to lock in short-term arbitrage profits.⁹⁵ Although similar to the positions described in § __.3(b)(2)(i)(A)(2) of the proposed definition (i.e., those acquired for the purpose of benefitting from actual or expected short-term price movements), this part of the definition focuses on short-term arbitrage profits more generally, without regard to whether the transaction is predicated on expected or actual movements in price. Rather, a position acquired to lock in arbitrage profits would include positions acquired or taken with the intent to benefit from differences in multiple market prices, even in cases in which no movement in those prices is necessary to realize the intended profit. Such arbitrage-based transactions might involve profiting from the difference in the market price of multiple related positions or assets, or might instead involve the difference in market price for particular price or risk elements associated with positions or assets. This would include, for example, arbitrage profits resulting from the convergence or divergence in prices between different positions held by a banking entity engaged in relative value convergence arbitrage, which involves marrying a long and short position to benefit from a convergence or divergence in price between the two, or any similar strategy, because such convergence or divergence could happen at any time (i.e., in one day, in sixty-one days, or some other time period).

Section __.3(b)(2)(i)(A)(4) of the proposed rule's definition of trading account includes covered financial positions acquired or taken for the purpose of hedging another position that is itself held in a trading account.⁹⁶ In particular, the Agencies assume that, with respect to any position the purpose of which is to hedge another covered financial position in the trading account, the banking entity generally intends to hold the hedging position, whatever its nominal duration, for only so long as the underlying position is held. Accordingly, the proposed rule makes clear that such hedging positions fall within the definition of trading account.

iii. Overview of current Market Risk Capital Rules approach to short-term trading positions.

The first prong of the proposed trading account definition, which references positions acquired principally for short-term trading purposes, is, like the statutory definition it implements, substantially similar to a key portion of the definition of a "covered position" under the Market Risk Capital Rules.⁹⁷ For the reasons discussed below, the Agencies have taken this

⁹⁵ See proposed rule § __.3(b)(2)(i)(A)(3).

⁹⁶ See proposed rule § __.3(b)(2)(i)(A)(4).

⁹⁷ The Federal banking agencies' current Market Risk Capital Rules are located at 12 CFR 3, Appendix B (OCC), 12 CFR 208, Appendix E and 12 CFR 225, Appendix E (Board), and 12 CFR 325, Appendix C (FDIC), and apply on a consolidated basis to banks and bank holding companies with trading activity (on a worldwide consolidated basis) that equals 10 percent or more of the institution's total assets, or \$1 billion or more. On January 11, 2011, the Federal banking agencies proposed revisions to the Market Risk Capital Rules that include, *inter alia*, changes to the definition of covered position. Proposed revisions to the Market Risk Capital Rules include (i) changes to portions of the covered position definition not relevant to the statutory definition of trading account in section 13 of the BHC Act and (ii) the addition of a requirement that any position in a trading account also be a "trading position" in order to be considered a covered position. See 76 FR 1890 (Jan. 11, 2011). The revised definition of "trading position" that has been proposed for those purposes is generally identical to this proposed rule's definition of trading account

similarity into account and propose to construe the first prong of the definition of trading account under the proposed rule – and in particular its reference to “short-term” – in a manner that is consistent with the Market Risk Capital Rules’ approach to identifying positions taken with short-term trading intent.

The Market Risk Capital Rules define a covered position to include all positions in a bank’s “trading account,” as that term is defined, in part, in the Report of Condition and Income that banks are required to file periodically with respect to their financial condition (“Call Report”). Under the Market Risk Capital Rules, a covered position is one that is subject to a risk-based capital charge that is based, at least in part, on the banking organization’s internal risk management models for purposes of calculating the banking organization’s risk-based capital requirement.⁹⁸ In defining the term “trading account,” the Call Report notes that trading activities typically include, among other activities, “acquiring or taking positions in such items principally 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.”⁹⁹ This language is substantially identical to the statutory definition of trading account in section 13 of the BHC Act in that it refers to acquiring or taking positions (i) principally for the purpose of selling in the near-term or (ii) otherwise with the intent to resell in order to profit from short-term price movements.

In providing guidance regarding the application of “trading account,” the Call Report also states that trading account positions include any position that is classified as “trading securities” under relevant U.S. Generally Accepted Accounting Principles (“GAAP”) standards for accounting.¹⁰⁰ Under the referenced accounting standards, trading securities are defined as those “that are bought and held principally for the purpose of selling them in the near-term” and

(i.e., a position acquired or taken: (i) for the purpose of short-term resale; (ii) with the intent of benefitting from actual or expected short-term price movements; (iii) to lock in short-term arbitrage profits; or (iv) to hedge another trading position). The Agencies also note that the first prong of the proposed rule’s trading account definition is also substantially similar to the Basel Committee’s definition of “trading book.” See Basel Committee on Banking Supervision, Amendment to the Capital Accord to Incorporate Market Risks, available at <http://bis.org/publ/bcbs119.pdf>.

⁹⁸ The Agencies note that the Market Risk Capital Rules, both in their current and proposed form, also (i) include within the definition of covered position other positions not captured by the reference to positions acquired for the purpose of short-term resale or with the intent of benefitting from actual or expected short-term price movements (e.g., all commodity and foreign exchange positions, regardless of the intended holding period) and (ii) exclude from that definition certain positions otherwise acquired with short-term trading intent for a variety of policy reasons. The Agencies have not proposed to incorporate such inclusions or exclusions for purposes of the proposed rule’s definition of trading account; rather, the Market Risk Capital Rules and related concepts have been referred to only to the extent that they pertain to positions acquired for the purpose of short-term resale or with the intent of benefitting from actual or expected short-term price movements.

⁹⁹ Report of Condition and Income at A78a (also including, in the definition of “trading account,” “regularly underwriting or dealing in securities; interest rate, foreign exchange rate, commodity, equity, and credit derivative contracts; other financial instruments; and other assets for resale ... and ... acquiring or taking positions in such items as an accommodation to customers or for other trading purposes.”) Accordingly, given its broader scope, the Call Report “trading account” includes trading positions that fall outside the statutory “trading account” for purposes of determining what is prohibited and permitted covered trading activity under section 13 of the BHC Act.

¹⁰⁰ See Report of Condition and Income at A78a, referring to ASC Topic 320, Investments-Debt and Equity Securities (formerly FASB Statement of Financial Accounting Standards No. 115, “Accounting for Certain Investments in Debt and Equity Securities”).

“generally used with the objective of generating profits on short-term differences in price.”¹⁰¹ The Agencies note that the definition of a trading security under the relevant U.S. GAAP accounting standards is similar to both (i) the financial positions described in the second prong of the Call Report’s definition of trading account and (ii) the financial positions described in the statutory definition of trading account under section 13 of the BHC Act.

Although neither the Market Risk Capital Rules, the Call Report, nor relevant accounting standards provide a precise definition of what constitutes “near-term” or “short-term” for purposes of evaluating whether a position is of the type held in a trading account or is a trading security, guidance provided under relevant accounting standards notes that “near-term” for purposes of classifying trading activities is “generally measured in hours and days rather than months or years.”¹⁰² The Agencies expect that the precise period of time that may be considered near-term or short-term for purposes of evaluating any particular covered financial position would depend on a variety of factors, including the facts and circumstances of the covered financial position’s acquisition, the banking entity’s trading and business strategies, and the nature of the relevant markets. In considering the purpose for which a covered financial position is acquired or taken and evaluating whether such position is acquired or taken for short-term purposes, the Agencies intend to rely on a variety of information, including quantitative measurements of banking entities’ covered trading activities (as described below in Part II.B.5 of this Supplementary Information), supervisory review of banking entities’ compliance practices and internal controls, and supervisory review of individual transactions.

In order to better reinforce the general consistency between the proposal’s approach to defining a trading account and the “trading account” concept embedded in the Market Risk Capital Rules, the second prong of the proposed definition of trading account, contained in § __.3(b)(2)(i)(B) of the proposed rule, provides that a trading account includes any account used to acquire or take one or more covered financial positions, other than positions that are foreign exchange derivatives, commodity derivatives, or contracts of sale of a commodity for future delivery, that are also market risk capital rule covered positions, if the banking entity, or any affiliate of the banking entity that is a bank holding company, calculates risk-based capital ratios under the Market Risk Capital Rules.¹⁰³ For these purposes, a “market risk capital rule covered

¹⁰¹ See *id.* In formulating the proposed rule, the Agencies carefully considered whether to define trading account for purposes of the proposed rule in a manner that formally incorporated the accounting standards governing trading securities. The Agencies have not proposed this approach because: (i) the statutory proprietary trading prohibition under section 13 of the BHC Act applies to financial instruments, such as derivatives, to which the trading security accounting standards may not apply; (ii) these accounting standards permit companies to classify, at their discretion, assets as trading securities even where the assets would not otherwise meet the definition of trading security; and (iii) these accounting standards could change in the future without consideration of the potential impact on section 13 of the BHC Act.

¹⁰² See FASB ASC Master Glossary definition of “trading.” Although § __.3(b)(2)(ii) of the proposed rule includes a rebuttable presumption that an account used to acquire or take certain covered financial positions that are held for 60 days or less is a trading account, the Agencies note that U.S. GAAP does not include a presumption that securities sold within 60 days of acquisition were held for the purpose of selling them in the near term.

¹⁰³ The Agencies have excluded positions that are foreign exchange derivatives, commodity derivatives, or contracts of sale of a commodity for future delivery from this prong of the proposed trading account definition because all foreign exchange and commodity positions are considered “covered positions” under the Market Risk Capital Rules regardless of whether they involve the short-term trading intent required under the statutory definition of trading account in section 13(h)(6) of the BHC Act.

position” is defined as any covered position as that term is defined for purposes of (i) in the case of a banking entity that is a bank holding company or insured depository institution, the market risk capital rule that is applicable to the banking entity, and (ii) in the case of a banking entity that is affiliated with a bank holding company, other than a banking entity to which a market risk capital rule is applicable, the market risk capital rule that is applicable to the affiliated bank holding company.¹⁰⁴ In particular, for banking entities already subject to the Market Risk Capital Rules, it appears that positions subject to trading account treatment under those rules because they involve short-term trading intent are generally the type of positions to which the proprietary trading restrictions of section 13 of the BHC Act were intended to apply. In addition, including all covered financial positions that receive trading account treatment under the Market Risk Capital Rules because they meet a nearly identical standard regarding short-term trading intent would also eliminate the potential for inconsistency or regulatory arbitrage in which a banking entity might characterize a position as “trading” for capital purposes but not for purposes of the proposed rule.

The Agencies emphasize that this second prong of the trading account definition is being proposed in contemplation of the proposed revisions to the Market Risk Capital Rules and, in particular, the proposed definition of “covered position” under those proposed revisions. To the extent that those proposed revisions with respect to the definition of “covered position” are not adopted, or adopted in a form other than as proposed, the Agencies would expect to take that into account in determining whether or how to include the proposed second prong of the trading account definition for purposes of the final rule to implement section 13 of the BHC Act.¹⁰⁵

iv. Positions acquired or taken by securities dealers, swap dealers, and security-based swap dealers.

The third prong of the proposed definition of trading account is contained in § __.3(b)(2)(i)(C) of the proposed rule and provides that a trading account includes any account used to acquire or take one or more covered financial positions by a banking entity that is: (i) a SEC-registered securities or municipal securities dealer; (ii) a government securities dealer that registered, or that has filed notice, with an appropriate regulatory agency;¹⁰⁶ (iii) a CFTC-

¹⁰⁴ See proposed rule § __.3(c)(8). Accordingly, in the context of a subsidiary of a bank holding company (other than a subsidiary, such as a bank, to which a market risk capital rule is already directly applicable), if that bank holding company is subject to a market risk capital rule, any position of that subsidiary that meets the definition of a “covered position” under the market risk capital rule applicable to the bank holding company would be subject to § __.3(b)(2)(i)(B) of the proposed rule.

¹⁰⁵ In particular, the Agencies note that under the proposed revisions to the Market Risk Capital Rules, but not the existing Market Risk Capital Rule, the term “covered position” expressly includes, other than with respect to commodity and foreign exchange positions, only positions taken with short-term trading intent. See 76 FR 1890 (Jan. 11, 2011). The Agencies do not intend to incorporate “covered positions” under the Market Risk Capital Rules in a way that includes positions lacking short-term trading intent.

¹⁰⁶ See 15 U.S.C. 78c(a)(42)(E); 15 U.S.C. 78o-5(a)(1)(B); 17 CFR 400.5(b); 17 CFR 449.1. Section 15C(a)(1)(A) of the Exchange Act requires any government securities dealer, other than a registered broker-dealer or a financial institution, to register with the SEC pursuant to section 15C(a)(2). Registered broker-dealers and financial institutions are required to file written notice with their appropriate regulatory agency, as defined in section 3(a)(34) of the Exchange Act, prior to acting as a government securities dealer. See 15 U.S.C. 78o-5(a)(1)(B). The proposed definition of trading account would cover positions of all three forms of government securities dealers: (i) those

registered swap dealer; or (iv) a SEC-registered security-based swap dealer, in each case to the extent that the covered financial position is acquired or taken in connection with the activities that require the banking entity to be registered, or to file notice, as such.¹⁰⁷ Similarly included is any covered financial position acquired or taken by a banking entity that is engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, if such position is acquired or taken in connection with the activities of such business.¹⁰⁸ As a result of this third prong, all covered financial positions acquired or taken by a registered dealer, swap dealer or security-based swap dealer, a government securities dealer that has filed notice with an appropriate regulatory agency, or a banking entity engaged in the same type of dealing activities outside the United States, are automatically included within the scope of positions described in the trading account definition, if they are acquired or taken in connection with the activities that require the banking entity to be registered, or file notice, as such (or, in the case of a banking entity engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, in connection with the activities of such business). As discussed below, the proposed rule contains exemptions that permit a variety of covered trading activity in which these types of entities typically engage, notwithstanding the inclusion of all covered financial positions of such entities within the definition of trading account.

The Agencies have proposed this third prong of the trading account definition because all assets or other positions held by firms that register or file notice as securities or derivatives dealers as part of their dealing activity are generally held for sale to customers upon request or otherwise support the firm's trading activities (e.g., by hedging its dealing positions), and so would appear to be captured within the statutory definition of trading account. To the extent that a covered financial position is acquired or taken by such a banking entity outside the scope of the dealing activities that require the banking entity to be registered, or to file notice, as a dealer, swap dealer, or security-based swap dealer, that position may still cause the relevant account to be a trading account under the proposed rule if the account holding such a position otherwise meets the terms of the first or second prong of the trading account definition (i.e., positions acquired or taken for short-term trading purposes or certain Market Risk Capital Rules positions).

v. Rebuttable presumption for certain positions.

In order to provide greater clarity and guidance on the application of the trading account definition, and in particular for those banking entities with no experience in evaluating short-

registered with the SEC; (ii) registered broker-dealers; and (iii) financial institutions that have filed notice with an appropriate regulatory agency.

¹⁰⁷ See proposed rule § __.3(b)(2)(i)(C)(1)-(4). The Agencies emphasize that this provision applies only to positions taken in connection with the activities that require the banking entity to be registered as one of the listed categories of dealer, not to all of the activities of that banking entity. For example, an insured depository institution may be registered as a swap dealer, but only the swap dealing activities that require it to be so registered would be covered by the second prong of the trading account definition. A position taken in connection with other activities of the insured depository institution that do not trigger registration as a swap dealer, such as lending, deposit-taking, the hedging of business risks, or other end-user activity, would only be included within the trading account if the position met one of the other prongs of the trading account definition (i.e., §§ __.3(b)(2)(i)(A) or (B) of the proposed rule).

¹⁰⁸ See proposed rule § __.3(b)(2)(i)(C)(5).

term trading intent or that are not subject to the Market Risk Capital Rules, the proposed rule also includes a rebuttable presumption regarding certain positions that, by reason of their holding period, are presumed to be trading account positions. In particular, § __.3(b)(2)(ii) of the proposed rule provides that an account would be presumed to be a trading account if it is used to acquire or take a covered financial position, other than dealing positions or certain Market Risk Capital Rules covered positions that are automatically considered part of the trading account, that the banking entity holds for a period of sixty days or less. However, the presumption does not apply if the banking entity can demonstrate, based on all the facts and circumstances, that the covered financial position, either individually or as a category, was not acquired or taken principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position.¹⁰⁹ Because it appears likely that most positions held for sixty days or less would have been acquired with short-term trading intent, the proposal presumes such positions are trading account positions unless the banking entity can demonstrate otherwise. The purpose of the proposed rebuttable presumption is to simplify the process of evaluating whether individual positions are included in the definition of trading account. The proposal does not apply this rebuttable presumption to positions described in § __.3(b)(2)(i)(B) or (C) of the proposed rule (i.e., certain Market Risk Capital Rules positions and dealing positions), because these positions are automatically part of the trading account, and cannot be rebutted.

However, the Agencies recognize that, for a variety of reasons, a banking entity may acquire a covered financial position for purposes other than short-term trading but nonetheless dispose of that position within the sixty-day period covered by the presumption. Accordingly, § __.3(b)(2)(ii) is only a presumption, and may be rebutted by reference to all the facts and circumstances surrounding the acquisition of a particular position. For example, if a banking entity acquired a covered financial position with the demonstrable intent of holding it for investment or other non-trading purposes but, because of developments not expected or anticipated at the time of acquisition (e.g., increased customer demand, an unexpected increase in its volatility or a need to liquidate the position to meet unexpected liquidity demands), held it for less than sixty days, those facts and circumstances would generally suggest that the position was not acquired with short-term trading intent, notwithstanding the presumption.¹¹⁰ The proposed rule also makes clear that this rebuttal may be made not only with respect to a particular transaction, but also with respect to a particular category of transactions, recognizing that it may be possible to identify a category of similar transactions that clearly do not involve short-term trading, notwithstanding the typical holding period of the related positions.

It is important to note that these presumptions are designed to help determine whether a transaction is within the definition of “proprietary trading,” not whether a transaction is permissible under section 13 of the BHC Act. A transaction may fall within the definition of “proprietary trading” and yet be permissible if it meets one of the exemptions provided in the proposed rule, such as the exemption for market making-related activities.

¹⁰⁹ See proposed rule § __.3(b)(2)(ii).

¹¹⁰ In such cases, the documented intention for acquiring or taking the position should be consistent with the intention articulated for financial reporting and other purposes.

vi. Request for comment.

The Agencies request comment on the proposed rule's approach to defining trading account. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule's definition of trading account effective? Is it over- or under-inclusive in this context? What alternative definition might be more effective in light of the language and purpose of the statute? How would such definition better identify the accounts that are intended to be covered by section 13 of the BHC Act?

Question [•]. Is the proposed rule's approach for determining when a position falls within the definition of "trading account" for purposes of the proposed rule from when it must be reported in the "trading account" for purpose of filing the Call Report effective? What additional guidance could the Agencies provide on this distinction? Are there alternative approaches that would be more effective in light of the language and purpose of the statute? Is this approach workable for affiliates of bank holding companies that are not subject to the Federal banking agencies' market Risk Capital Rules (e.g., affiliated investment advisers)? If not, why not? Are affiliates of bank holding companies familiar with the concepts from the Market Risk Capital Rules that are being incorporated into the proposed rule? If not, what steps would an affiliate of a bank holding company have to take to become familiar with these concepts and what would be the costs and/or benefits of such actions? Is application of the trading account concept from the Federal banking agencies' Market Risk Capital Rules to affiliates of bank holding companies necessary to promote consistency and prevent regulatory arbitrage? Please explain.

Question [•]. Is the manner in which the Agencies intend to take into account, and substantially adopt, the approach used in the Market Risk Capital Rules and related concepts for determining whether a position is acquired with short-term trading intent effective?

Question [•]. Should the proposed rule's definition of trading account, or its use of the term "short-term," be clarified? Are there particular transactions or positions to which its application would be unclear? Should the proposed rule define "short-term" for these purposes? What alternative approaches to construing the term "short-term" should the Agencies consider and/or adopt?

Question [•]. Are there particular transactions or positions to which the application of the proposed definition of trading account is unclear? Is additional regulatory language, guidance, or clarity necessary?

Question [•]. Is the exchange of variation margin as a potential indicator of short-term trading in derivative or commodity future transactions appropriate for the definition of trading account? How would this impact such transactions or the manner by which banking entities conduct such transactions? For instance, would banking entities seek to avoid the use of variation margin to avoid this rule? What are the costs and benefits of referring to the exchange of variation margin to determine if positions should be included in a banking entity's trading account? Please explain.

Question [•]. Are there particular transactions or positions that are included in the definition of trading account that should not be? If so, what transactions or positions and why?

Question [•]. Are there particular transactions or positions that are not included in the definition of trading account that should be? If so, what transactions or positions and why?

Question [•]. Is the proposed rule of construction for positions acquired or taken by dealers, swap dealers and security-based swap dealers appropriate and consistent with the purpose and language of section 13 of the BHC Act? Is its application to any particular type of entity, such as an insured depository institution engaged in derivatives dealing activities, sufficiently clear and effective? If not, what alternative would be clearer and/or more effective?

Question [•]. Is the rebuttable presumption included in the proposed rule appropriate and effective? Are there more effective ways in which to provide clarity regarding the determination of whether or not a position is included within the definition of trading account? If so, what are they?

Question [•]. Are records currently created and retained that could be used to demonstrate investment or other non-trading purposes in connection with rebutting the presumption in the proposed rule? If yes, please identify such records and explain when they are created and whether they would be useful in connection with a single transaction or a category of similar transactions. If no, we seek commenter input regarding the manner in which banking entities might demonstrate investment or other non-trading intent. Should the Agencies require banking entities to make and keep records to demonstrate investment or non-trading intent with respect to their covered financial positions?

Question [•]. How should the proposed trading account definition address arbitrage positions? Should all arbitrage positions be included in the definition of trading account, unless the timing of such profits is long-term and established at the time the arbitrage position is acquired or taken? Please explain in detail, including a discussion of different arbitrage trading strategies and whether subjecting such strategies to the proposed rule would be consistent with the language and purpose of section 13 of the BHC Act.

Question [•]. Is the holding period referenced in the rebuttable presumption appropriate? If not, what holding period would be more appropriate, and why?

Question [•]. Should the proposed rule include a rebuttable presumption regarding positions that are presumed not to be within the definition of trading account? If so, why, and what would the presumption be?

Question [•]. Should any additional accounts be included in the proposed rule pursuant to the authority granted under section 13(h)(6) of the BHC Act? If so, what accounts and why? For example, should accounts used to acquire or take certain long-term positions be included in the definition? If so, how would subjecting such accounts to the proposed rule's prohibitions and restrictions be consistent with the language and purpose of section 13 of the BHC Act?

Question [•]. Do any of the activities currently engaged in by issuers of asset-backed securities that would be considered a banking entity constitute proprietary trading as defined by §__.3(b) of this rule proposal? Would any activities relating to investment of funds in accounts held by issuers of asset-backed securities (e.g., reserve accounts, prefunding accounts, reinvestment accounts, etc.) or the purchase and sale of securities as part of the management of a

collateralized debt obligation portfolio be considered proprietary trading under the proposed rule? What would be the potential impact of the prohibition on proprietary trading on the use of such accounts in (i) existing securitization transactions and (ii) future securitization transactions? Would any of the securities typically acquired and retained using these accounts be considered an ownership interest in a covered fund under the proposed rule? Does the exclusion of trading in certain government obligations in § __.6(a) of the proposed rule mitigate the impact of the proposed rule on such issuers of asset-backed securities and their activities? Why or why not?

c. Excluded positions.

i. Excluded positions under certain repurchase and reverse repurchase arrangements.

Section __.3(b)(2)(iii)(A) of the proposed rule's definition of trading account provides that an account will not be a trading account to the extent that such account is used to acquire or take one or more covered financial positions that arise under a repurchase or reverse repurchase agreement pursuant to which the banking entity has simultaneously agreed, in writing at the start of the transaction, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty.¹¹¹ This clarifying exclusion is proposed because positions held under a repurchase or reverse repurchase agreement operate in economic substance as a secured loan, and are not based on expected or anticipated movements in asset prices. Accordingly, these types of asset purchases and sales do not appear to be the type of transaction intended to be covered by the statutory definition of trading account.

ii. Excluded positions under securities lending transactions.

Section __.3(b)(2)(iii)(B) of the proposed rule's definition of trading account provides that an account will not be a trading account to the extent that such account is used to acquire or take one or more covered financial positions that arise under a transaction in which the banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and to recall the loaned security on terms agreed to by the parties.¹¹² This clarifying exclusion is proposed because a position held under a securities lending arrangement operates, in economic substance and function, as a means to facilitate settlement of securities transactions, and is not based on expected or anticipated movements in asset prices. Accordingly, securities lending transactions do not appear to be the type of transaction intended to be covered by the statutory definition of trading account.

iii. Excluded positions acquired or taken for liquidity management purposes.

Section __.3(b)(2)(iii)(C) of the proposed definition of trading account provides that an account will not be a trading account to the extent that such account is used to acquire or take a

¹¹¹ See proposed rule § __.3(b)(2)(iii)(A).

¹¹² See proposed rule § __.3(b)(2)(iii)(B). The language describing securities lending transactions in the proposed rule generally mirrors that contained in Rule 3a5-3 under the Exchange Act. See 17 CFR 240.3a5-3.

position for the purpose of bona fide liquidity management, so long as important criteria are met.¹¹³

This proposed clarifying exclusion is intended to make clear that, where the purpose for which a banking acquires or takes a position is to ensure that it has sufficient liquid assets to meet its short-term cash demands, and the related position is held as part of the banking entity's liquidity management process, that transaction falls outside of the types of transactions described in the proposed rule's definition of trading account. Maintaining liquidity management positions is a critical aspect of the safe and sound operation of certain banking entities, and does not involve the requisite short-term trading intent that forms the basis of the statutory definition of "trading account." In the context of bona fide liquidity management activity that would qualify for the clarifying exclusion, a banking entity's purpose for acquiring or taking these types of positions is not to benefit from short-term profit or short-term price movements, but rather to ensure that it has sufficient, readily-marketable assets available to meet its expected short-term liquidity needs.

However, the Agencies are concerned with the potential for abuse of this clarifying exclusion – specifically, that a banking entity might attempt to improperly mischaracterize positions acquired or taken for prohibited proprietary trading purposes as positions acquired or taken for liquidity management purposes. To address this, the proposed rule requires that the transaction be conducted in accordance with a documented liquidity management plan that meets five criteria. First, the plan would be required to specifically contemplate and authorize any particular instrument used for liquidity management purposes, its profile with respect to market, credit and other risks, and the liquidity circumstances in which the position may or must be used. Second, the plan would have to require that any transaction contemplated and authorized by the plan be principally for the purpose of managing the liquidity of the banking entity, and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position acquired or taken for such short-term purposes. Third, the plan would have to require that any positions acquired or taken for liquidity management purposes be highly liquid and limited to financial instruments the market, credit and other risks of which are not expected to give rise to appreciable profits or losses as a result of short-term price movements.¹¹⁴ Fourth, the plan would be required to limit any position acquired or taken for liquidity management purposes, together with any other positions acquired or taken for such purposes, to an amount that is consistent with the banking entity's near-term funding needs, including deviations from normal operations, as estimated and documented pursuant to methods specified in the plan. Fifth, the plan would be required to be consistent with the relevant Agency's supervisory requirements, guidance and expectations regarding liquidity management. The Agencies would review these liquidity plans and transactions effected in accordance with these plans through supervisory and examination processes to ensure that the applicable criteria are met and that any position acquired or taken in

¹¹³ See proposed rule § __.3(b)(2)(iii)(C).

¹¹⁴ Any instance in which positions characterized as taken for liquidity purposes do give rise to appreciable profits or losses as a result of short-term price movements will be subject to significant Agency scrutiny and, absent compelling explanatory facts and circumstances, would be viewed as prohibited proprietary trading under the proposal.

reliance on the clarifying exclusion for liquidity management transactions is fully consistent with such plans.

iv. Excluded positions of derivatives clearing organizations and clearing agencies.

Section __.3(b)(2)(iii)(D) of the proposed rule's definition of trading account provides that an account will not be a trading account to the extent that such account is used to acquire or take one or more covered financial positions that are acquired or taken by a banking entity that is a derivatives clearing organization registered under section 5b of the Commodity Exchange Act (7 U.S.C. 7a-1) or a clearing agency registered with the SEC under section 17A of the Exchange Act (15 U.S.C. 78q-1) in connection with clearing derivatives or securities transactions.¹¹⁵ This clarifying exclusion is proposed because, in the case of a banking entity that acts as a registered, central counterparty in the securities or derivatives markets, these types of transactions do not appear to be the type of transaction intended to be covered by the statutory definition of trading account, as the purpose of such transactions is to provide a clearing service to third parties and not to profit from short-term resale or short-term price movements.

v. Request for comment.

The Agencies request comment regarding the proposed clarifying exclusions and whether any other types of activity or transactions should be excluded from the proposed definition of trading account for clarity. In particular, the Agencies request comment on the following questions:

Question [•]. Are the proposed clarifying exclusions for positions under certain repurchase and reverse repurchase arrangements and securities lending transactions over- or under-inclusive and could they have unintended consequences? Is there an alternative approach to these clarifying exclusions that would be more effective? Are the proposed clarifying exclusions broad enough to include bona fide arrangements that operate in economic substance as secured loans and are not based on expected or anticipated movements in asset prices? Are there other types of arrangements, such as open dated repurchase arrangements, that should be excluded for clarity and, if so, how should the proposed rule be revised? Alternatively, are the proposed clarifying exclusions narrow enough to not inadvertently exclude from coverage any similar arrangements or transactions that do not have these characteristics?

Question [•]. Are repurchase and reverse repurchase arrangements and securities lending transactions sufficiently similar that they should be treated in the same way for purposes of the proposed rule? Are there aspects of repurchase and reverse repurchase arrangements or securities lending transactions that should be highlighted in considering the application of the proposed rule? Do repurchase and reverse repurchase arrangements or securities lending transactions raise any additional or heightened concerns regarding risk? Please identify and explain how these concerns should be reflected in the proposed rule.

Question [•]. Are the proposed exclusions for repurchase and reverse repurchase arrangements and securities lending transactions appropriate or are there conditions that

¹¹⁵ See proposed rule § __.3(b)(2)(iii)(D).

commenters believe would be appropriate as a pre-requisite to relying on these exclusions? Please identify such conditions and explain. Alternatively, we seek commenter input regarding why repurchase and reverse repurchase arrangements and securities lending transactions do not present the potential for abuse, namely, that a banking entity might attempt to improperly mischaracterize prohibited proprietary trading as activity that qualifies for the proposed exclusions.

Question [•]. Is the proposed clarifying exclusion for liquidity management transactions effective and appropriate? If not, what alternative would be more effective and appropriate, and why? Is the proposed exclusion under- or over-inclusive? Does the proposed clarifying exclusion place sufficient limitations on liquidity management transactions to prevent abuse of the clarifying exclusion? If not, what additional limitations should be specified? Are any of the limitations contained in the proposed rule inappropriate or unnecessary? If so, how could such limitations be eliminated or altered in way that does not permit abuse of the clarifying exclusion?

Question [•]: Is the proposed exclusion for liquidity management positions necessary? If not excluded, would such activity otherwise qualify for an exemption contained in the proposed rule (e.g., the exemptions contains in §§ __.5 and __.6(a) of the proposed rule)? What types of banking entities are likely to engage in the liquidity management activities described in the proposed exclusion?

Question [•]: What types of instruments do particular types of banking entities currently use in connection with liquidity management activities (e.g., Treasuries)? Why are such instruments chosen for liquidity management purposes? Would such instruments meet the proposed requirement that the position be highly liquid and limited to financial instruments the market, credit and other risk of which are not expected to give rise to appreciable profits or losses as a result of short-term price movements? Why or why not?

Question [•]: What methodologies do banking entities currently use for estimating deviations from normal operations in connection with liquidity management programs?

Question [•]: Which unit or units within a banking entity is typically responsible for liquidity management? What is the typical reporting line structure used to control and supervise that unit or units? Are the responsibilities of personnel in the unit limited to liquidity management or do they perform other functions in addition to liquidity management? How is compensation determined for personnel in the unit of the banking entity responsible for liquidity management?

Question [•]: Would current liquidity management programs meet the five proposed criteria for liquidity management programs? If not which criteria would not be met, and why? What effect would the proposed liquidity management exclusions have on current liquidity management programs and banking entities in general?

Question [•]: Are liquidity management programs used for purposes other than ensuring the banking entity has sufficient assets available to it that are readily marketable to meet expected short-term liquidity needs? If so, for what purposes, and why?

Question [•]: What costs or other burdens would arise if the proposal did not contain an exclusion for positions acquired or taken for liquidity management purpose? Please explain and quantify these costs or other burdens in detail.

Question [•]: Is the proposed liquidity management exclusion sufficiently clear? If not, why is the exclusion unclear and how should the Agencies clarify the terms of this exclusion?

Question [•]. Is the proposed clarifying exclusion for certain positions taken by derivatives clearing organizations and clearing agencies effective and appropriate? If not, what alternative would be more effective and appropriate, and why?

Question [•]. Are any additional clarifying exclusions warranted? If so, what clarifying exclusion, and why?

Question [•]. Should the proposed definition exclude any position the market risk of which cannot be hedged by the banking entity in a two-way market?¹¹⁶ If so, what would be the basis for concluding that such positions are clearly not within the statutory definition of trading account?

Question [•]. Should the proposed definition include a clarifying exclusion for any position in illiquid assets? If so, what would be the basis for concluding that such positions are clearly not within the statutory definition of trading account? How should “illiquid assets” be defined for these purposes? Should the definition be consistent with the definition given that term in the Board’s Conformance Rule under section 13 of the BHC Act (12 CFR 225.180 et seq.)?¹¹⁷

d. Covered financial position.

i. Definition of “covered financial position”.

Section __.3(b)(3)(i) of the proposed rule defines a covered financial position as any long, short, synthetic or other position¹¹⁸ in: (i) a security, including an option on a security; (ii)

¹¹⁶ The Agencies also note that such an exclusion would be similar to the express exclusion of similar positions under the Federal banking agencies’ most recent proposed revisions to the Market Risk Capital Rules. *See* 76 FR 1890, 1912 (Jan. 11, 2011) (excluding from the definition of a covered position any position the material risk elements of which the holder is unable to hedge in a two-way market).

¹¹⁷ *See* 76 FR 8265 (Feb. 14, 2011). The Board’s conformance rule defines “illiquid asset” as “any real property, security obligation, or other asset that (i) is not a liquid asset; (ii) because of statutory or regulatory restrictions applicable to the hedge fund, private equity fund or asset, cannot be offered, sold, or otherwise transferred by the hedge fund or private equity fund to a person that is unaffiliated with the relevant banking entity; or (iii) because of contractual restrictions applicable to the hedge fund, private equity fund or asset, cannot be offered, sold, or otherwise transferred by the hedge fund or private equity fund for a period of 3 years or more to a person that is unaffiliated with the relevant banking entity.” 12 CFR 225.180(g). A “liquid asset” is defined in paragraph (h) of the conformance rule. *See* 12 CFR 225.180(h).

¹¹⁸ The proposed definition’s reference to any “long, short, synthetic or other position” is intended to make clear that a position in an identified category of financial instrument qualifies as a covered financial position regardless of whether the position is (i) an asset or liability or (ii) is acquired through acquisition or sale of the financial instrument or synthetically through a derivative or other transaction.

a derivative, including an option on a derivative; or (iii) a contract of sale of a commodity for future delivery, or an option on such a contract. The types of financial instruments described in the proposed definition are consistent with those referenced in section 13(h)(4) of the BHC Act as part of the statutory definition of proprietary trading.¹¹⁹

To provide additional clarity, § __.3(b)(3)(ii) of the proposed rule provides that, consistent with the statute, the term covered financial position does not include any position that is itself a loan, a commodity, or foreign exchange or currency.¹²⁰ The exclusion of these types of positions is intended to eliminate potential confusion by making clear that the purchase and sale of loans, commodities and foreign exchange – none of which are referred to in section 13(h)(4) of the BHC Act – are outside the scope of transactions to which the proprietary trading restrictions apply. The reference in § __.3(b)(3)(ii) to a position that is, rather than a position that is in, a loan, a commodity, or foreign exchange or currency is intended to capture only the purchase and sale of these instruments themselves. This reflects the fact that, consistent with section 13(h)(4) of the BHC Act and the proposed rule, although a position that is a foreign exchange derivative or commodity derivative is included in the definition of covered financial position and therefore subject to the prohibition on proprietary trading, a position that is a commodity or foreign currency is not.¹²¹ For example, the spot purchase of a commodity would meet the terms of the exclusion, but the acquisition of a futures position in the same commodity would not. The Agencies request comment on the proposed rule’s definition of covered financial position. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule’s definition of covered financial position effective? Is the definition over- or under-inclusive? What alternative approaches might be more effective in light of the language and purpose of section 13 of the BHC Act, and why?

Question [•]. Are there definitions in other rules or regulations that might inform the proposed definition of covered financial position? If so, what rule or regulation? How should that approach be incorporated into the proposed definition? Why would that approach be more appropriate?

Question [•]. Are there particular transactions or positions to which the application of the proposed definition of covered financial position is unclear? Is additional regulatory language, guidance, or clarity necessary?

Question [•]. The proposal would apply to long, short, synthetic, or other positions in one of the listed categories of financial instruments. Does this language adequately describe the type of positions that are intended to fall within the proposed definition of covered financial position? If not, why not? Are there different or additional concepts that should be specified in this context? Please explain.

¹¹⁹ Section 13(h)(4) of the BHC Act also permits the Agencies to extend the scope of the proprietary trading restrictions to other financial instruments. The Agencies have not proposed to do so at this time.

¹²⁰ See proposed rule § __.3(b)(ii).

¹²¹ The types of commodity- and foreign exchange-related derivatives that are included within the definition of “derivative” under the proposed rule are discussed in detail below in Part III.B.2.d.ii of this Supplementary Information.

Question [•]. Should the Agencies expand the scope of covered financial positions to include other transactions, such as spot commodities or foreign exchange or currency, or certain subsets of transaction (e.g., spot commodities or foreign exchange or currency traded on a high-frequency basis)? If so, which instruments and why?

Question [•]. What factors should the Agencies consider in deciding whether to extend the scope of the proprietary trading restriction to other financial instruments under the authority granted in section 13(h)(4) of the BHC Act? Please explain.

Question [•]. Is the proposed exclusion of any position that is a loan, a commodity, or foreign exchange or currency effective? If not, what alternative approaches might be more effective in light of the language and purpose of section 13 of the BHC Act? Should additional positions be excluded? If so, why and under what authority?

ii. Other terms used in the definition of covered financial position.

The proposal also defines a number of terms used in the proposed definition of covered financial position. The term “security” is defined by reference to that same term under the Exchange Act.¹²² The terms “commodity” and “contract of sale of a commodity for future delivery” are defined by reference to those same terms under the Commodity Exchange Act.¹²³ The Agencies have proposed to reference these existing definitions from the securities and commodities laws because these existing definitions are generally well-understood by market participants and have been subject to extensive interpretation in the context of securities and commodities trading activities.

The proposed rule also defines the term “derivative.”¹²⁴ In particular, the definition of “derivative” under the proposed rule includes any “swap” (as that term is defined in the Commodity Exchange Act) and any “security-based swap” (as that term is defined in the Exchange Act), in each case as further defined by the CFTC and SEC by joint regulation, interpretation, guidance, or other action, in consultation with the Board pursuant to section 712(d) of the Dodd-Frank Act. The Agencies have proposed to incorporate these definitions of “swap” and “security-based swap” under the Federal securities and commodities laws because those definitions: (i) govern the primary Federal regulatory scheme applicable to exchange-traded and over-the-counter derivatives; (ii) will be frequently evaluated and applied by banking entities in the course of their trading activities; and (iii) capture agreements and contracts that are or function as derivatives.¹²⁵ The proposed rule also includes within the definition of derivative certain other transactions that, although not included within the definition of “swap” or “security-based swap,” also appear to be, or operate in economic substance as, derivatives, and which if not included could permit banking entities to engage in proprietary trading that is inconsistent

¹²² See proposed rule § __.2(w).

¹²³ See proposed rule §§ __.3(c)(1), (2).

¹²⁴ See proposed rule § __.2(l).

¹²⁵ The Agencies note that they have not included a variety of security-related derivatives within the proposed definition of derivative, as such transactions are “securities” for purposes of both the Exchange Act and the proposed rule and, as a result, already included in the broader definition of “covered financial position” to which the prohibition on proprietary trading applies.

with the spirit of section 13 of the BHC Act. Specifically, the proposed definition of derivative also includes: (i) any purchase or sale of a nonfinancial commodity for deferred shipment or delivery that is intended to be physically settled; (ii) any foreign exchange forward or foreign exchange swap (as those terms are defined in the Commodity Exchange Act);¹²⁶ (iii) any agreement, contract, or transaction in foreign currency described in section 2(c)(2)(C)(i) of the Commodity Exchange Act (7 U.S.C. 2(c)(2)(C)(i));¹²⁷ (iv) any agreement, contract, or transactions in a commodity other than foreign currency described in section 2(c)(2)(D)(i) of the Commodity Exchange Act (7 U.S.C. 2(c)(2)(D)(i)); and (v) any transaction authorized under section 19 of the Commodity Exchange Act (7 U.S.C. 23(a) or (b)). The Agencies are requesting comment on whether including these five types of transactions within the proposed definition of derivative is appropriate.

To provide additional clarity, the proposed definition of derivative also clarifies two types of transactions that are outside the scope of the definition. First, the proposed definition of derivative would not include any consumer, commercial, or other agreement, contract, or transaction that the CFTC and SEC have further defined by joint regulation, interpretation, guidance, or other action as not within the definition of swap, as that term is defined in the Commodity Exchange Act, or security-based swap, as that term is defined in the Exchange Act. The SEC and CFTC have, in proposing rules further defining the terms “swap” and “security-based swap,” proposed to not include a variety of agreements, contracts, and transactions within those definitions by joint regulation or interpretation, and the Agencies have proposed to expressly reflect such exclusions in the proposed rule’s definition in order to avoid the potential

¹²⁶ The Agencies note that foreign exchange swaps and foreign exchange forwards are considered swaps for purposes of the Commodity Exchange Act definition of that term unless the Secretary of the Treasury determines, pursuant to section 1a(47)(E) of that Act (7 U.S.C. 1a(47)(E)), that foreign exchange swaps and forwards should not be regulated as swaps under the Commodity Exchange Act and are not structured to evade certain provisions of the Dodd-Frank Act. On May 5, 2011, the Treasury Secretary proposed to exercise that authority to exclude foreign exchange forwards and foreign exchange swaps from the definition of “swap.” See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 76 FR 25774 (May 5, 2011). If the Secretary of the Treasury issues a final determination, as proposed, a “foreign exchange swap” and “foreign exchange forward” would be excluded from the definition of “swap” under the Commodity Exchange Act and, therefore, would fall outside of the proposed rule’s definition of “derivative.” Accordingly, the Agencies have proposed to expressly include such transactions in the proposed definition of derivative, but have requested comment on a variety of questions related to whether foreign exchange swaps and forwards should be included or excluded from the definition of derivative. The Agencies note that, aside from foreign exchange swaps and forwards, the Commodity Exchange Act’s definition of “swap” (and therefore the proposed definition of “derivative”) also includes other types of foreign exchange derivatives, including non-deliverable foreign exchange forwards (NDFs), foreign exchange options, and currency options, which fall outside of the Secretary of the Treasury’s authority to issue a determination to exclude certain transactions from the “swap” definition.

¹²⁷ Section 2(c)(2)(C)(i) was added to the Commodity Exchange Act in 2008 to address retail foreign exchange transactions that were documented as automatically renewing spot contracts (so-called rolling spot transactions) and therefore not futures contracts subject to the Commodity Exchange Act, but which were functionally and economically similar to futures. See Retail Foreign Exchange Transactions, 76 FR 41375, 47376–77 (July 15, 2011). However, section 2(c)(2)(C)(i) of the Commodity Exchange Act does not apply to transactions entered into by U.S. financial institutions, including insured depository institutions, brokers, dealers, and certain retail foreign exchange dealers. See 7 U.S.C. 2(c)(2)(C)(i)(I)(aa). To apply this definitional prong to such banking entities, the definition of derivative includes a transaction “described in” section 2(c)(2)(C)(i) of the Commodity Exchange Act. In other words, the use of this phrase is intended to capture any transaction described in section 2(c)(2)(C)(i) without regard to the identity of the counterparty.

application of its restrictions to transactions that are not commonly thought to be derivatives.¹²⁸ Second, the proposed definition of derivative also does not include any identified banking product, as defined in section 402(b) of the Legal Certainty for Bank Products Act of 2000 (7 U.S.C. 27(b)), that is subject to section 403(a) of that Act (7 U.S.C. 27a(a)). This provision is proposed to clearly exclude identified banking products that are expressly excluded (i) from the definition of “security-based swap” and (ii) from Commodity Exchange Act and CFTC jurisdiction pursuant to section 403(a) of the Legal Certainty for Bank Products Act of 2000.¹²⁹

The proposed rule defines a “loan” as any loan, lease, extension of credit, or secured or unsecured receivable.¹³⁰ The Agencies note that the proposed definition of loan is expansive, and includes a broad array of loans and similar credit transactions, but does not include any asset-backed security that is issued in connection with a loan securitization or otherwise backed by loans.

The Agencies request comment on the proposed rule’s definition of terms used in the definition of covered financial position. In particular, the Agencies request comment on the following questions:

Question [•]. Are the proposed rule’s definitions of commodity and contract of sale of a commodity for future delivery appropriate? If not, what alternative definitions would be more appropriate?

Question [•]. Is the proposed definition of derivative effective? If not, what alternative definition would be more effective? Should the proposed rule expressly incorporate the definition of “swap” and security-based swap” under the Federal commodities and securities laws? If not, what alternative approach should be taken? Are there transactions included in those incorporated definitions that should not be included in the proposed rule’s definition? If so, what transactions and why? Are there transactions excluded from those incorporated definitions that should be included within the proposed rule’s definition? If so, what transactions and why?

Question [•]. Is the proposed inclusion of foreign exchange forwards and swaps in the definition of derivative effective? If not, why not? On what basis would the Agencies conclude that such transactions are not derivatives? Are these transactions economically or functionally

¹²⁸ See 76 FR 29818 (May 23, 2011). For example, the SEC and CFTC have proposed to not include (i) certain insurance products within the definitions of “swap” and “security-based swap” by regulation and (ii) certain consumer agreements (e.g., agreements to acquire or lease real property or purchase products at a capped price) and commercial agreements (e.g., employment contracts or the purchase of real property, intellectual property, equipment or inventory) by joint interpretation. See *id.* at 29832-34. The Agencies have proposed to define “derivative” in the proposed rule by reference to the definition of “swap” and “security-based swap” under the Federal securities and commodities laws in contemplation of the SEC and CFTC’s proposed regulatory and interpretative exclusions; to the extent that such exclusions are not included in any final action taken by the SEC and CFTC, the Agencies will consider whether to state such exclusions expressly within the proposed rule’s definition of derivative.

¹²⁹ Examples of excluded identified banking products are deposit accounts, savings accounts, certificates of deposit, or other deposit instruments issued by a bank.

¹³⁰ See proposed rule § __.2(q).

more similar to secured loans or repurchase arrangements than to commodity forwards and swaps? Would there be any unintended consequences to banking entities if such transactions are included in the proposal's definition of derivative? What effect is including foreign exchange swaps and forwards in the definition of derivative likely to have on banking entities, participants in the foreign exchange markets, and the liquidity and efficiency of foreign exchange markets generally? If included within the definition of derivative, should transactions in foreign exchange swaps and forwards be permitted under section 13(d)(1)(J) of the BHC Act? If so, why and on what basis? Please quantify your responses, to the extent feasible.

Question [•]. Is the proposed inclusion of any purchase or sale of a nonfinancial commodity for deferred shipment or delivery that is intended to be physically settled in the definition of derivative effective? If not, why not? Would there be any unintended consequences to banking entities if such transactions are included in the proposal's definition of derivative?

Question [•]. Is the proposed inclusion of foreign currency transactions described in section 2(c)(2)(C)(i) of the Commodity Exchange Act in the definition of derivative effective? If not, why not? Would there be any unintended consequences to banking entities if such transactions are included in the proposal's definition of derivative?

Question [•]. Is the proposed inclusion of commodity transactions described in section 2(c)(2)(D)(i) of the Commodity Exchange Act in the definition of derivative effective? If not, why not? Would there be any unintended consequences to banking entities if such transactions are included in the proposal's definition of derivative?

Question [•]. Is the proposed inclusion of any transaction authorized under section 19 of the Commodity Exchange Act (7 U.S.C. 23(a) or (b)) in the definition of derivative effective? If not, why not? Would there be any unintended consequences to banking entities if such transactions are included in the proposal's definition of derivative?

Question [•]. Is the manner in which the proposed definition of derivative excludes any transaction that the CFTC or SEC exclude by joint regulation, interpretation, guidance, or other action from the definition of "swap" or "security-based swap" effective? If not, what alternative approach would be more appropriate? Should such exclusions be restated in the proposed rule's definition? If so, why?

Question [•]. Is the proposed rule's definition of loan appropriate? If not, what alternative definition would be more appropriate? Should the definition of "loan" exclude a security? Should other types of traditional banking products be included in the definition of "loan"? If so, why?

iii. Definition of other terms related to proprietary trading.

Section __.3(d) of the proposed rule defines a variety of other terms used throughout subpart B of the proposed rule. These definitions are discussed in further detail below in the relevant summary of the separate sections of the proposed rule in which they are used.

The Agencies request comment on the proposed rule's definition of other terms used in subpart B of the proposed rule. In particular, the Agencies request comment on the following questions:

Question [•]. Are the proposed rule's definitions of other terms in § __.3(d) appropriate? If not, what alternative definitions would be more appropriate?

Question [•]. Is the definition of additional terms for purposes of subpart B of the proposed rule necessary? If so, what terms should be defined? How should those terms be defined?

2. Section __.4: Permitted underwriting and market making-related activities.

Section __.4 of the proposed rule implements section 13(d)(1)(B) of the BHC Act, which permits banking entities to engage in certain underwriting and market making-related activities, notwithstanding the prohibition on proprietary trading.¹³¹ Section __.4(a) addresses permitted underwriting activities, and § __.4(b) addresses permitted market making-related activities.

a. Permitted underwriting activities.

Section __.4(a) of the proposed rule permits a banking entity to purchase or sell a covered financial position in connection with the banking entity's underwriting activities to the extent that such activities are designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties (the "underwriting exemption"). In order to rely on this exemption, a banking entity's underwriting activities must meet all seven of the criteria listed in § __.4(a)(2). These seven criteria are intended to ensure that any banking entity relying on the underwriting exemption is engaged in *bona fide* underwriting activities, and conducts those activities in a way that is not susceptible to abuse through the taking of speculative, proprietary positions as a part of, or mischaracterized as, underwriting activity.

First, the banking entity must have established the internal compliance program required by subpart D of the proposed rule, as further described below in Part III.D of this Supplementary Information. This requirement is intended to ensure that any banking entity relying on the underwriting exemption has reasonably designed written policies and procedures, internal controls, and independent testing in place to support its compliance with the terms of the exemption.

Second, the covered financial position that is being purchased or sold must be a security. This requirement reflects the common usage and understanding of the term "underwriting."¹³²

Third, the transaction must be effected solely in connection with a distribution of securities for which the banking entity is acting as an underwriter. This prong is intended to give effect to the essential element of the underwriting exemption – i.e., that the transaction be in

¹³¹ See 12 U.S.C. 1851(d)(1)(B).

¹³² The Agencies note, however, that a derivative or commodity future transaction may be otherwise permitted under another exemption (e.g., the exemptions for market making-related or risk-mitigating hedging activities).

connection with underwriting activity. For these purposes, the proposed rule defines both (i) a distribution of securities and (ii) an underwriter. The definitions of these terms are generally identical to the definitions provided for the same terms in the SEC's Regulation M,¹³³ which governs the activities of underwriters, issuers, selling security holders, and others in connection with offerings of securities under the Exchange Act.¹³⁴ The Agencies have proposed to use similar definitions because the meanings of these terms under Regulation M are generally well-understood by market participants and define the scope of underwriting activities in which banking entities typically engage, including underwriting of SEC-registered offerings, underwriting of unregistered distributions, and acting as a placement agent in private placements.

With respect to the definition of distribution, the Agencies note that Regulation M defines a distribution of securities as “an offering of securities, whether or not subject to registration under the Securities Act that are distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts.”¹³⁵ The manner in which this Regulation M definition distinguishes a distribution of securities from other transactions appears to be relevant in the context of the underwriting exemption and useful to address potential evasion of the general prohibition on proprietary trading, while permitting bona fide underwriting activities. Accordingly, in order to qualify as a distribution for purposes of the proposal, as with Regulation M, the offering must meet the two elements – “magnitude” and “special selling efforts and selling methods.” The Agencies have not defined the terms “magnitude” and “special selling efforts and selling methods” in the proposed rule, but would expect to rely on the same factors considered under Regulation M in assessing these elements. For example, the number of shares to be sold, the percentage of the outstanding shares, public float, and trading volume that those shares represent are all relevant to an assessment of magnitude.¹³⁶ In addition, delivering a sales document, such as a prospectus, and conducting road shows are generally indicative of special selling efforts and selling methods.¹³⁷ Another indicator of special selling efforts and selling methods is compensation that is greater than that for secondary trades but consistent with underwriting compensation for an offering. Similar to the approach taken under Regulation M, the Agencies note that “magnitude” does not imply that a distribution must be large; instead, this factor is a means to distinguish a distribution from ordinary trading, and therefore does not preclude small offerings or private placements from qualifying for the underwriting exemption.

The definition of “underwriter” in the proposed rule is generally similar to that under the SEC's Regulation M, except that the proposed rule's definition would also include, within that definition, a person who has an agreement with another underwriter to engage in a distribution of securities for or on behalf of an issuer or selling security holder.¹³⁸ Consistent with current

¹³³ 17 CFR 242.100 et seq.

¹³⁴ See proposed rule §§ __.4(a)(3), (4); 17 CFR 242.100(b).

¹³⁵ 17 CFR 242.100.

¹³⁶ See Review of Antimanipulation Regulation of Securities Offering, Exchange Act Release No. 33924 (Apr. 19, 1994), 59 FR 21681, 21684 (Apr. 26, 1994) (“Regulation M Concept Release”).

¹³⁷ See Regulation M Concept Release, 59 FR at 21684-85.

¹³⁸ See proposed rule § __.4(a)(4)(ii).

practices and the Council study, the Agencies propose to take into consideration the extent to which the banking entity is engaged in the following activities when determining whether a banking entity is acting as an underwriter as part of a distribution of securities:

- Assisting an issuer in capital raising;
- Performing due diligence;
- Advising the issuer on market conditions and assisting in the preparation of a registration statement or other offering documents;
- Purchasing securities from an issuer, a selling security holder, or an underwriter for resale to the public;
- Participating in or organizing a syndicate of investment banks;
- Marketing securities; and
- Transacting to provide a post-issuance secondary market and to facilitate price discovery.

The Agencies note that the precise activities performed by an underwriter may vary depending on the liquidity of the securities being underwritten and the type of distribution being conducted. For example, each factor need not be present in a private placement.

There may be circumstances in which an underwriter would hold securities that it could not sell in the distribution for investment purposes. If the acquisition of such unsold securities were in connection with the underwriting pursuant to the permitted underwriting activities exemption, the underwriter would also be able to dispose of such securities at a later time.¹³⁹

Fourth, to the extent that the transaction involves a security for which a person must generally be a U.S.-registered securities dealer, municipal securities dealer or government securities dealer in order to underwrite the security, the banking entity must have the appropriate dealer registration (or in the case of a financial institution that is a government securities dealer, has filed notice of that status as required by section 15C(a)(1)(B) of the Exchange Act) or otherwise be exempt from registration or excluded from regulation as a dealer.¹⁴⁰ Similarly, if the banking entity is engaged in the business of a dealer outside the United States in a manner for which no U.S. registration is required, the banking entity must be subject to substantive

¹³⁹ The Agencies note, however, that such sale would have to be made in compliance with other applicable provisions of the Federal securities laws and regulations.

¹⁴⁰ See proposed rule § __.4(a)(2)(iv). For example, if a banking entity is a bank engaged in underwriting asset-backed securities for which it would be required to register as a securities dealer but for the exclusion contained in section 3(a)(5)(C)(iii) of the Exchange Act, the proposed rule would not require that banking entity be a registered securities dealer in order to rely on the underwriting exemption for that transaction. The proposed rule does not apply the dealer registration/notice requirement to the underwriting of exempted securities, security-based swaps, commercial paper, bankers acceptances or commercial bills because the underwriting of such instruments does not require registration as a securities dealer under the Exchange Act.

regulation of its dealing business in the jurisdiction in which the business is located. This requirement is intended to ensure that (i) any underwriting activity conducted in reliance on the exemption is subject to appropriate regulation and (ii) banking entities are not simultaneously characterizing the transaction as underwriting for purposes of the exemption while characterizing it in a different manner for purposes of applicable securities laws.

Fifth, the underwriting activities of the banking entity with respect to the covered financial position must be designed not to exceed the reasonably expected near-term demands of clients, customers and counterparties.¹⁴¹ This requirement restates the statutory limitation on the underwriting exemption.

Sixth, the underwriting activities of the banking entity must be designed to generate revenues primarily from fees, commissions, underwriting spreads or other income, and not from appreciation in the value of covered financial positions it holds related to such activities or the hedging of such covered financial position.¹⁴² This requirement is intended to ensure that activities conducted in reliance on the underwriting exemption demonstrate patterns of revenue generation and profitability consistent with, and related to, the services an underwriter provides to its customers in bringing securities to market, rather than changes in the market value of the securities underwritten.

Seventh, the compensation arrangements of persons performing underwriting activities at the banking entity must be designed not to encourage proprietary risk-taking. Activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of securities underwritten, rather than success in bringing securities to market for a client, are inconsistent with permitted underwriting activities under the proposed rule. Although a banking entity relying on the underwriting exemption may appropriately take into account revenues resulting from movements in the price of securities that the banking entity underwrites to the extent that such revenues reflect the effectiveness with which personnel have managed underwriting risk, the banking entity should provide compensation incentives that primarily reward client revenues and effective client service, not proprietary risk-taking.

The Agencies request comment on the proposed rule's implementation of the underwriting exemption. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule's implementation of the underwriting exemption effective? If not, what alternative approach would be more effective? For example, should the exemption include other transactions that do not involve a distribution of securities for which the banking entity is acting as underwriter?

¹⁴¹ See proposed rule § __.4(a)(2)(v).

¹⁴² For these purposes, underwriting spreads would include any "gross spread" (i.e., the difference between the price an underwriter sells securities to the public and the price it purchases them from the issuer) designed to compensate the underwriter for its services.

Question [•]. Are the seven requirements included in the underwriting exemption effective? Is the application of each requirement to potential transactions sufficiently clear? Should any of the requirements be changed or eliminated? Should other requirements be added in order to better provide an exemption that is not susceptible to abuse through the taking of speculative, proprietary positions in the context of, or mischaracterized as, underwriting? Alternatively, are any of the proposed requirements too restrictive? If so, how?

Question [•]. Do underwriters currently have processes in place that would prevent or reduce the likelihood of taking speculative, proprietary positions in the context of, or mischaracterized as, underwriting? If so, what are those processes?

Question [•]. Would any of the proposed requirements cause unintended consequences? Would the proposed requirements alter current underwriting practices in any way? Would any of the proposed requirements trigger an unwillingness to engage in underwriting? What, if any impact, would the proposed exemption have on capital raising? Please explain.

Question [•]. What increased costs, if any, would underwriters incur to satisfy the seven proposed requirements of the underwriting exemption? Would underwriters pass the increased costs onto issuers, selling security holders, or their customers in connection with qualifying for the proposed exemption?

Question [•]. In addition to the specific activities highlighted above for purposes of evaluating whether a banking entity is acting as an underwriter as part of distribution of securities (e.g., assisting an issuer in capital raising, performing due diligence, etc), are there other or alternative activities that should be considered? Please explain.

Question [•]. Should the requirement that a covered financial position be a security be expanded to include other financial instruments? If so, why? How are such other instruments underwritten within the meaning of section 13(d)(1)(B) of the BHC Act?

Question [•]. Is the proposed definition of a “distribution” of securities appropriate, or over- or under-inclusive in this context? Is there any category of underwriting activity that would not be captured by the proposed definition? If so, what are the mechanics of that underwriting activity? Should it be permitted under the proposed rule, and, if so, why? Would an alternative definition better identify offerings intended to be covered by the proposed definition? If so, what alternative definition, and why?

Question [•]. Is the proposed definition of “underwriter” appropriate, or over- or under-inclusive in this context? Would an alternative definition, such as the statutory definition of “underwriter” under the Securities Act, better identify persons intended to be covered by the proposed definition? If so, why?

Question [•]. How accurately can a banking entity engaging in underwriting predict the near-term demands of clients, customers, and counterparties with respect to an offering? How can principal risk that is retained in connection with underwriting activities to support near-term client demand be distinguished from positions taken for speculative purposes?

Question [•]. Is the requirement that the underwriting activities of a banking entity relying on the underwriting exemption be designed to generate revenues primarily from fees, commissions, underwriting spreads or similar income effective? If not, how should the requirement be changed? Does the requirement appropriately capture the type and nature of revenues typically generated by underwriting activities? Is any further clarification or additional guidance necessary?

Question [•]. Is the requirement that the compensation arrangements of persons performing underwriting activities at a banking entity be designed not to reward proprietary risk-taking effective? If not, how should the requirement be changed? Are there other types of compensation incentives that should be clearly referenced as consistent, or inconsistent, with permitted underwriting activity? Are there specific and identifiable characteristics of compensation arrangements that clearly incentivize prohibited proprietary trading?

Question [•]. Are there other types of underwriting activities that should also be included within the scope of the underwriting exemption? If so, what additional activities and why? How would an exemption for such additional activities be consistent with the language and purpose of section 13 of the BHC Act? What criteria, requirements, or restrictions would be appropriate to include with respect to such additional activities to prevent misuse or evasion of the prohibition on proprietary trading?

Question [•]. Does the proposed underwriting exemption appropriately accommodate private placements? If not, what changes are necessary to do so?

Question [•]. The creation, offer and sale of certain structured securities such as trust preferred securities or tender option bonds, among others, may involve the purchase of another security and repackaging of that security through an intermediate entity. Should the sale of the security by a banking entity to an intermediate entity as part of the creation of the structure security be permitted under one of the exemptions to the prohibition on proprietary trading currently included in the proposed rule (e.g., underwriting or market making)? Why or why not? For purposes of determining whether an exemption is available under these circumstances, should gain on sale resulting from the sale of the purchased security to the intermediate entity as part of the creation of the structured security be considered a relevant factor? Why or why not? What other factors should be considered in connection with the creation of the structured securities and why? Would the analysis be different if the banking entity acquired and retained the security to be sold to the intermediate entity as part of the creation of the structured securities as part of its underwriting of the underlying security? Why or why not?

Question [•]. We seek comment on the application of the proposed exemption to a banking entity retaining a portion of an underwriting. Please discuss whether or not firms frequently retain securities in connection with a distribution in which the firm is acting as underwriter. Please identify the types of offerings in which this may be done (e.g., fixed income offerings, securitized products, etc.). Please identify and discuss any circumstances which can contribute to the decision regarding whether or not to retain a portion of an offering. Please describe the treatment of retained securities (e.g., the time period of retention, the type of account in which securities are retained, the potential disposition of the securities). Please discuss whether or not the retention is documented and, if so, how. Should the Agencies require

disclosure of securities retained in connection with underwritings? Should the Agencies require specific documentation to demonstrate that the retained portion is connected to an underwriting pursuant to the proposed rule? If so, what kind of documentation should be required? Please discuss how you believe retention should be addressed under the proposal.

b. Permitted market making-related activities.

Section __.4(b) of the proposed rule permits a banking entity to purchase or sell a covered financial position in connection with the banking entity's market making-related activities (the "market-making exemption").

i. Approach to implementing the exemption for market making-related activities.

As the Council study noted, implementing the statutory exception for permitted market making-related activities requires a regulatory regime that differentiates permitted market making-related activity, and in particular the taking of principal positions in the course of making a market in particular financial instruments, from prohibited proprietary trading. Although the purpose and function of these two activities are markedly different – market making-related activities provide intermediation and liquidity services to customers, while proprietary trading involves the generation of profit through speculative risk-taking – clearly distinguishing these activities may be difficult in practice. Market making-related activities, like prohibited proprietary trading, sometimes require the taking of positions as principal, and the amount of principal risk that must be assumed by a market maker varies considerably by asset class and differing market conditions.¹⁴³ It may be difficult to distinguish principal positions that appropriately support market making-related activities from positions taken for short-term, speculative purposes. In particular, it may be difficult to determine whether principal risk has been retained because (i) the retention of such risk is necessary to provide intermediation and liquidity services for a relevant financial instrument or (ii) the position is part of a speculative trading strategy designed to realize profits from price movements in retained principal risk.¹⁴⁴

In order to address these complexities, the Agencies have proposed a multi-faceted approach that draws on several key elements. First, similar to the underwriting exemption, the proposed rule includes a number of criteria that a banking entity's activities must meet in order to rely on the exemption for market making-related activities. These criteria are intended to ensure that the banking entity is engaged in bona fide market making. As described in greater detail in Part III.D of the Supplementary Information, among these criteria is the requirement that the banking entity have in place a programmatic compliance regime to guide its compliance with section 13 of the BHC Act and the proposed rule. This compliance regime includes requirements that a banking entity have effective policies, procedures, and internal controls that

¹⁴³ With respect to certain kinds of market making-related activities, such as market making in securities, these principal positions are often referred to as "inventory" or "inventory positions." However, since certain types of market making-related activities, such as market making in derivatives, involve the retention of principal positions arising out of multiple derivatives transactions in particular risks (e.g., retained principal interest rate risk), rather than retention of actual financial instruments, the broader term "principal positions" is used in this discussion.

¹⁴⁴ The Council study contains a detailed discussion of the challenges involved in delineating prohibited proprietary trading from permitted market making-related activities. See Council study at 15-18.

are designed to ensure that prohibited proprietary trading positions are not taken under the guise of permitted market making-related activity. Second, as described in greater detail in Part III.B.5 of this Supplementary Information, Appendix B of the proposed rule contains a detailed commentary regarding how the Agencies propose to identify permitted market making-related activities. This commentary includes six principles the Agencies propose to use as a guide to help distinguish market-making related activities from prohibited proprietary trading. Third, also as described in greater detail in Part III.B.5 of this Supplementary Information, § __.7 and Appendix A of the proposed rule require a banking entity with significant covered trading activities to report certain quantitative measurements for each of its trading units.¹⁴⁵ These quantitative measurements are intended to assist both banking entities and the Agencies in assessing whether the quantitative profile of a trading unit (e.g., the types of revenues it generates and the risks it retains) is consistent with permitted market making-related activities under the proposed rule.

The proposal's multi-faceted approach is intended, through the incorporation of multiple regulatory and supervisory tools, to strike an appropriate balance in implementing the market-making exemption in a way that articulates the scope of permitted activities and meaningfully addresses the potential for misuse of the exemption, while not unduly constraining the important liquidity and intermediation services that market makers provide to their customers and to the capital markets at large.

The Agencies request comment on the proposed rule's approach to implementing the exemption for permitted market making-related activities. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule's approach to implementing the exemption for permitted market making-related activities (i) appropriate and (ii) likely to be effective? If not, what alternative approach would be more appropriate or effective?

Question [•]. Does the proposed multi-faceted approach appropriately take into account and address the challenges associated with differentiating prohibited proprietary trading from permitted market making-related activities? Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

Question [•]. Does the proposed multi-faceted approach provide banking entities and market participants with sufficient clarity regarding what constitutes permitted market making-related activities? If not, how could greater clarity be provided?

Question [•]. What impact will the proposed multi-faceted approach have on the market making-related services that a banking entity provides to its customers? How will the proposed approach impact market participants who use the services of market makers? How will the approach impact the capital markets at large, and in particular the liquidity, efficiency and price transparency of capital markets? If any of these impacts are positive, how can they be

¹⁴⁵ The definition of "trading unit" for this purpose is discussed in detail in Part III.B.5 of this Supplementary Information.

amplified? If any of these impacts are negative, how can they be mitigated? Would the proposed rule's prohibition on proprietary trading and exemption for market making-related activity reduce incentives or opportunities for banking entities to trade against customers, as opposed to trading on behalf of customers? If so, please discuss the benefits arising from such reduced incentives or opportunities.

Question [•]. What burden will the proposed multi-faceted approach have on banking entities, their customers, and other market participants? How can any burden be minimized or eliminated in a manner consistent with the language and purpose of the statute?

Question [•]. Are there particular asset classes that raise special concerns in the context of market making-related activity that should be considered in connection with the proposed market-making exemption? If so, what asset class(es) and concern(s), and how should the concerns be addressed in the proposed exemption?

ii. Required criteria for permitted market making-related activities.

As part of the proposal's multi-faceted approach to implementing the exemption for permitted market making-related activities, § __.4(b)(2) of the proposed rule specifies seven criteria that a banking entity's market making-related activities must meet in order to rely on the exemption, each of which are described in detail below. These criteria are designed to ensure that any banking entity relying on the exemption is engaged in bona fide market making-related activities and conducts those activities in a way that is not susceptible to abuse through the taking of speculative, proprietary positions as a part of, or mischaracterized as, market making-related activity.

First criterion - establishment of internal compliance program.

Section __.4(b)(2)(i) of the proposed rule requires a banking entity to establish a comprehensive compliance program to monitor and control its market making-related activities. Subpart D of the proposed rule further describes the appropriate elements of an effective compliance program. This criterion is intended to ensure that any banking entity relying on the market-making exemption has reasonably designed written policies and procedures, internal controls, and independent testing in place to support its compliance with the terms of the exemption.

Second criterion - bona fide market making.

Section __.4(b)(2)(ii) of the proposed rule articulates the core element of the statutory exemption, which is that the activity must be market making-related. In order to give effect to this requirement, § __.4(b)(2)(ii) of the proposed rule requires the trading desk or other organizational unit that purchases or sells a particular covered financial position to hold itself out as being willing to buy and sell, or otherwise enter into long and short positions in, the covered financial position for its own account on a regular or continuous basis. Notably, this criterion requires that a banking entity relying on the exemption with respect to a particular transaction must actually make a market in the covered financial position involved; simply because a banking entity makes a market in one type of covered financial position does not permit it to rely

on the market-making exemption for another type of covered financial position.¹⁴⁶ Similarly, the particular trading desk or other organizational unit of the banking entity that is relying on the exemption for a particular type of covered financial position must also be the trading desk or other organizational unit that is actually making the market in that covered financial position; market making in a particular covered financial position by one trading desk of a banking entity does not permit another trading desk of the banking entity to rely on the market-making exemption for that type of covered financial position.

The language used in § __.4(b)(2)(ii) of the proposed rule to describe bona fide market making-related activity is similar to the definition of “market maker” under section 3(a)(38) of the Exchange Act.¹⁴⁷ The Agencies have proposed to use similar language because the Exchange Act definition is generally well-understood by market participants and is consistent with the scope of bona fide market making-related activities in which banking entities typically engage.

In assessing whether a particular trading desk or other organizational unit holds itself out as being willing to buy and sell, or otherwise enter into long and short positions in, a covered financial position for its own account on a regular or continuous basis in liquid markets, the Agencies expect to take an approach similar to that used by the SEC in the context of assessing whether a person is engaging in bona fide market making. The precise nature of a market maker’s activities often varies depending on the liquidity, trade size, market infrastructure, trading volumes and frequency, and geographic location of the market for any particular covered financial position. In the context of relatively liquid positions, such as equity securities or other exchange-traded instruments, a trading desk or other organizational unit’s market making-related activity should generally include:

- Making continuous, two sided quotes and holding oneself out as willing to buy and sell on a continuous basis;
- A pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity;
- Making continuous quotations that are at or near the market on both sides; and
- Providing widely accessible and broadly disseminated quotes.¹⁴⁸

¹⁴⁶ The Agencies note that a market maker may often make a market in one type of covered financial positions and hedge its activities using different covered financial positions in which it does not make a market. Such hedging transactions would meet the terms of the market-making exemption if the hedging transaction met the requirements of § __.4(b)(3) of the proposed rule.

¹⁴⁷ Section 3(a)(38) of the Exchange Act defines “market maker” as “any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer quotation communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.” 15 U.S.C. 78c(a)(38).

¹⁴⁸ The Agencies note that these indicia are generally consistent with the indicia of bona fide market making in equity markets articulated by the SEC for purposes of describing the exception to the locate requirement of the SEC’s Regulation SHO for market makers engaged in bona fide market-making activities. See Exchange Act

In less liquid markets, such as over-the-counter markets for debt and equity securities or derivatives, the appropriate indicia of market making-related activities will vary, but should generally include:

- Holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis;¹⁴⁹
- With respect to securities, regularly purchasing covered financial positions from, or selling the positions to, clients, customers, or counterparties in the secondary market; and
- Transaction volumes and risk proportionate to historical customer liquidity and investments needs.¹⁵⁰

The Agencies recognize that these indicia cannot be applied at all times and under all circumstances because some may be inapplicable to the specific asset class or market in which the market making activity is conducted.

The bona fide market making-related activity described in § __.4(b)(2)(ii) of the proposed rule would include block positioning if undertaken by a trading desk or other organizational unit of a banking entity for the purpose of intermediating customer trading.¹⁵¹ In addition, bona fide market making-related activity may include taking positions in securities in

Release No. 58775 (October 14, 2008), 73 FR 61690, 61698-61699 (Oct. 17, 2008); see also 17 CFR 242.203(b)(2)(iii).

¹⁴⁹ The frequency of such regular quotations will itself vary; less illiquid markets may involve quotations on a daily or more frequent basis, while highly illiquid markets may trade only by appointment.

¹⁵⁰ The Agencies also note that the CFTC and SEC have identified, in a proposed rule further defining the terms “swap dealer” and “security-based swap dealer” under the Commodity Exchange Act and Exchange Act, a variety of distinguishing characteristics of swap dealers and security-based swap dealers in the context of derivatives, including that: (i) dealers tend to accommodate demand for swaps and security-based swaps from other parties; (ii) dealers are generally available to enter into swaps or security-based swaps to facilitate other parties’ interest in entering into those instruments; (iii) dealers tend not to request that other parties propose the terms of swaps or security-based swaps, but instead tend to enter into those instruments on their own standard terms or on terms they arrange in response to other parties’ interest; and (iv) dealers tend to be able to arrange customized terms for swaps or security-based swaps upon request, or to create new types of swaps or security-based swaps at the dealer’s own initiative. See 75 FR 80174, 80176 (Dec. 21, 2010).

¹⁵¹ The definition of “market maker” in the Exchange Act includes a dealer acting in the capacity of a block positioner. Although the term “block positioner” is not defined in the proposed rule, the Agencies note that the SEC has adopted a definition of “qualified block positioner” in the SEC’s Rule 3b-8(c) (17 CFR 240.3b-8(c)), which may serve as guidance in determining whether a block positioner engaged in block positioning is engaged in bona fide market making-related activities for purposes of § __.4(b)(2)(ii) of the proposed rule. Under the SEC’s Rule 3b-8(c), among other things, a qualified block positioner must meet all of the following conditions: (i) engages in the activity of purchasing long or selling short, from time to time, from or to a customer (other than a partner or a joint venture or other entity in which a partner, the dealer, or a person associated with such dealer participates) a block of stock with a current market value of \$200,000 or more in a single transaction, or in several transactions at approximately the same time, from a single source to facilitate a sale or purchase by such customer; (ii) has determined in the exercise of reasonable diligence that the block could not be sold to or purchased from others on equivalent or better terms; and (iii) sells the shares comprising the block as rapidly as possible commensurate with the circumstances. The Agencies note that the rule establishes a minimum dollar value threshold for a block. The size of a block will vary among different asset classes.

anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties.

Third criterion - reasonably expected near-term demands of clients, customers, and counterparties.

Under § __.4(b)(2)(iii) of the proposed rule, the market making-related activities of the trading desk or other organization unit that conducts a transaction in reliance on the market-making exemption must be designed not to exceed the reasonably expected near-term demands of clients, customers, and counterparties. This criterion implements the language in section 13(d)(1)(B) of the BHC Act and is intended to prevent a trading desk relying on the market-making exemption from taking a speculative proprietary position unrelated to customer needs as part of its purported market making-related activities. As described in further detail in Parts III.B.5 and III.D of the Supplementary Information, the proposed rule also includes a programmatic compliance requirement and requires reporting of quantitative measurements for certain banking entities, both of which are designed, in part, to meaningfully circumscribe the principal positions taken as part of market making-related activities to those which are necessary to meet the reasonably expected near-term demands of clients, customers and counterparties. The Agencies expect that the programmatic compliance requirement and required reporting of quantitative measurements will play an important role in assessing a banking entity's compliance with § __.4(b)(2)(iii)'s requirement. In addition, as described in Part II.B.5 of the Supplementary Information, Appendix B of the proposed rule provides additional, detailed commentary regarding how the Agencies expect a firm relying on the market-making exemption to manage principal positions and how the Agencies propose to assess whether such positions are consistent with market making-related activities under the proposed rule.

In order for a banking entity's expectations regarding near-term customer demand to be considered reasonable, such expectations should be based on more than a simple expectation of future price appreciation and the generic increase in marketplace demand that such price appreciation reflects. Rather, a banking entity's expectation should generally be based on the unique customer base of the banking entity's specific market-making business lines and the near-term demands of those customers based on particular factors beyond a general expectation of price appreciation. To the extent that a trading desk or other organizational unit of a banking entity is engaged wholly or principally in trading that is not in response to, or driven by, customer demands, the Agencies would not expect those activities to qualify under § __.4(b) of the proposed rule, regardless of whether those activities promote price transparency or liquidity. For example, a trading desk or other organizational unit of a banking entity that is engaged wholly or principally in arbitrage trading with non-customers would not meet the terms of the proposed rule's market making exemption. In the case of a market maker engaging in market making in a security that is executed on an organized trading facility or exchange, that market maker's activities are generally consistent with reasonably expected near-term customer demand when such activities involve passively providing liquidity by submitting resting orders that interact with the orders of others in a non-directional or market-neutral trading strategy and the market maker is registered, if the exchange or organized trading facility registers market

makers.¹⁵² However, activities by such a person that primarily takes liquidity on an organized trading facility or exchange, rather than provides liquidity, would not qualify for the market-making exemption under the proposed rule, even if those activities were conducted by a registered market maker.

Fourth criterion - registration under securities or commodities laws.

Under § __.4(b)(2)(iv) of the proposed rule, a banking entity relying on the market-making exemption with respect to trading in securities or certain derivatives must be appropriately registered as a dealer, or exempt from registration or excluded from regulation as a dealer, under applicable securities or commodities laws. With respect to a market-making transaction in one or more covered financial positions that are securities, other than exempted securities, security-based swaps, commercial paper, bankers acceptances or commercial bills, for which a person must be a U.S.-registered securities dealer, municipal securities dealer or government securities dealer in order to deal in the security, the banking entity must have the appropriate dealer registration (or in the case of a financial institution that is a government securities dealer, has filed notice of that status as required by section 15C(a)(1)(B) of the Exchange Act) or otherwise be exempt from registration or excluded from regulation as a dealer.¹⁵³ Similarly, with respect to a market-making transaction involving a swap or security-based swap for which a person must generally be a U.S.-registered swap dealer or security-based swap dealer, respectively, the banking entity must be appropriately registered or otherwise be exempt from registration or excluded from regulation as a swap dealer or security-based swap dealer.¹⁵⁴ If the banking entity is engaged in the business of a securities dealer, swap dealer or security-based swap dealer outside the United States in a manner for which no U.S. registration is required, the banking entity must be subject to substantive regulation of its dealing business in the jurisdiction in which the business is located. This requirement is intended to ensure that (i) any market making-related activity conducted in reliance on the exemption is subject to appropriate regulation and (ii) a banking entity does not simultaneously characterize the

¹⁵² The Agencies emphasize that the status of being a registered market maker is not, on its own, a sufficient basis for relying on the exemption for market making-related activity contained in § __.4(b). However, being a registered market maker is required under these circumstances if the applicable exchange or organized trading facility registers market makers. Registration as a market maker generally involves filing a prescribed form with an exchange or organized trading facility, in accordance with its rules and procedures, and complying with the applicable requirements for market makers set forth in the rules of that exchange or organized trading facility. *See, e.g.*, Nasdaq Rule 4612, New York Stock Exchange Rule 104, CBOE Futures Exchange Rule 515, BATS Exchange Rule 11.5.

¹⁵³ *See* proposed rule §§ __.4(b)(2)(iv)(A), (D), (E). For example, if a banking entity is a bank engaged in market-making in qualified Canadian government obligations for which it would be required to register as a securities dealer but for the exclusion contained in section 3(a)(5)(C)(i)(I) of the Exchange Act, the proposed rule would not require that banking entity to be a registered securities dealer in order to rely on the market-making exemption for that market-making transaction. Such a bank would, however, be required to file notice that it is a government securities dealer and comply with rules applicable to financial institutions that are government securities dealers. *See* 15 U.S.C. 78c(a)(42)(E); 15 U.S.C. 78o-5(a)(1)(B); 17 CFR 400.5(b); 17 CFR 449.1. Similar to the underwriting exemption, the proposed rule does not apply the dealer registration requirement to market making in securities that are exempted securities, commercial paper, bankers acceptances or commercial bills because dealing in such securities does not require registration as securities dealer under the Exchange Act; however, registering as a municipal securities dealer or government securities dealer is required, if applicable.

¹⁵⁴ *See* proposed rule §§ __.4(b)(2)(iv)(B), (C).

transaction as market making-related for purposes of the exemption while characterizing it in a different manner for purposes of applicable securities or commodities laws.

Fifth criterion - revenues from fees, commissions, bid/ask spreads or other similar income.

Under § __.4(b)(2)(v) of the proposed rule, the market making-related activities of the banking entity must be designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to appreciation in the value of covered financial positions it holds in trading accounts or the hedging of such positions. This criterion is intended to ensure that activities conducted in reliance on the market-making exemption demonstrate patterns of revenue generation and profitability consistent with, and related to, the intermediation and liquidity services a market maker provides to its customers, rather than changes in the market value of the positions or risks held in inventory. Similar to the requirement that a firm relying on the market-making exemption design its activities not to exceed reasonably expected near-term client, customer, or counterparty demands, the Agencies expect that the programmatic compliance requirement and required reporting of quantitative measurements will play an important role in assessing a banking entity's compliance with § __.4(b)(2)(v)'s requirement. In addition, as described in Part III.B.5 of this Supplementary Information, Appendix B of the proposed rule provides additional, detailed commentary regarding how the Agencies propose to assess whether the types of revenues generated by a banking entity relying on the market-making exemption are consistent with market making-related activities.

Sixth criterion - compensation incentives.

Under § __.4(b)(2)(vii) of the proposed rule, the compensation arrangements of persons performing market making-related activities at the banking entity must be designed not to encourage or reward proprietary risk-taking. Activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a covered financial position held in inventory, rather than success in providing effective and timely intermediation and liquidity services to customers, are inconsistent with permitted market making-related activities. Although a banking entity relying on the market-making exemption may appropriately take into account revenues resulting from movements in the price of principal positions to the extent that such revenues reflect the effectiveness with which personnel have managed principal risk retained, a banking entity relying on the market-making exemption should provide compensation incentives that primarily reward customer revenues and effective customer service, not proprietary risk-taking. In addition, as described in Part III.B.5 of this Supplementary Information, Appendix B of the proposed rule provides further commentary regarding how the Agencies propose to assess whether the compensation incentives provided to trading personnel performing trading activities in reliance on the market-making exemption are consistent with market making-related activities.

Seventh criterion – consistency with Appendix B commentary.

Under § __.4(b)(2)(vi) of the proposed rule, the market making-related activities of the trading desk or other organizational unit that conducts the purchase or sale are required to be consistent with the commentary provided in Appendix B, which provides guidance that the Agencies propose to apply to help distinguish permitted market making-related activities from

prohibited proprietary trading. Appendix B's proposed commentary, which is described in detail below in Part III.B.5 of this Supplementary Information, discusses various factors by which the Agencies propose to distinguish prohibited proprietary trading from permitted market making-related activities (e.g., how and to what extent a market maker hedges the risk of its market-making transactions, including (i) further detail related directly to other criteria in § __.4(b)(2) (e.g., the types of revenues generated by market makers), and (ii) expectations regarding other factors not expressly included in § __.4(b)(2)).

B. Market making-related hedging.

Section __.4(b)(3) of the proposed rule provides that certain hedging transactions related to market-making positions and holdings will also be deemed to be made in connection with a banking entity's market making-related activities for purposes of the market-making exemption. In particular, § __.4(b)(3) provides that the purchase or sale of a covered financial position for hedging purposes will qualify for the market-making exemption if it meets two requirements. First, the purchase or sale must be conducted in order to reduce the specific risks to the banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings acquired pursuant to the market-making exemption. Where the purpose of a transaction is to hedge a market making-related position, it would appear to be market making-related activity of the type described in section 13(d)(1)(B) of the BHC Act. Second, the hedging transaction must also meet the criteria specified in the general exemption for risk-mitigating hedging activity for purposes of the proprietary trading prohibition, which is contained in §§ __.5(b) and (c) of the proposed rule and described in detail in Part III.B.3 of this Supplementary Information. Those criteria are intended to clearly define the scope of appropriate risk-mitigating hedging activities, to foreclose reliance on the exemption for prohibited proprietary trading that is conducted in the context of, or mischaracterized as, hedging activity, and to require documentation regarding the hedging purpose of certain transactions that are established at a level of organization that is different than the level of organization establishing or responsible for the underlying risk or risks that are being hedged, which in the context of the market making-related activity would generally be the trading desk.

iii. Request for comment.

The Agencies request comment on the proposed criteria that must be met in order to rely on the market-making exemption. In particular, the Agencies request comment on the following questions (as well as related questions in Part III.B.5 of this Supplementary Information):

Question [•]. Are the seven criteria included in the market-making exemption effective? Is the application of each criterion to potential transactions sufficiently clear? Should any of the criteria be changed or eliminated? Should other criteria be added?

Question [•]. Is incorporation of concepts from the definition of "market maker" under the Exchange Act useful for purposes of section 13 of the BHC Act and consistent with its purposes? If not, what alternative definition would be more useful or more consistent?

Question [•]. Is the proposed exemption overly broad or narrow? For example, would it encompass activity that should be considered prohibited proprietary trading under the proposed

rule? Alternatively, would it prohibit forms of market making or market making-related activities that are permitted under other rules or regulations?

Question [•]. We seek commenter input on the types of banking entities and forms of activities that would not qualify for the proposed market-making exemption but that commenters consider to otherwise be market making. Please discuss the impact of not permitting such activities under the proposed exemption (e.g., the impact on liquidity).

Question [•]. Is the requirement that a trading desk or other organizational unit relying on the market-making exemption hold itself out as being willing to buy and sell, or otherwise enter into long and short positions in, the relevant covered financial position for its own account on a regular or continuous basis effective? If not, what alternative would be more effective? Does the proposed requirement appropriately differentiate between market making-related activities in different markets and asset classes? If not, how could such differences be better reflected? Should the requirement be modified to include certain arbitrage trading activities engaged in by market makers that promote liquidity or price transparency, but do not serve customer, client or counterparty demands, within the scope of market making-related activity? If so why? How could such liquidity- or price transparency-promoting activities be meaningfully identified and distinguished from prohibited proprietary trading practices that also may incidentally promote liquidity or price transparency? Do particular markets or instruments, such as the market for exchange-traded funds, raise particular issues that are not adequately or appropriately addressed in the proposal? If so, how could the proposal better address those instruments, markets or market features?

Question [•]. Do the proposed indicia of market making in liquid markets accurately reflect the factors that should generally be used to analyze whether a banking entity is engaged in market making-related activities for purposes of section 13 of the BHC Act and the proposed rule? If not, why not? Should any of the proposed factors be eliminated or modified? Should any additional factors be included? Is reliance on the SEC's indicia of bona fide market making for purposes of Regulation SHO under the Exchange Act and the equity securities market appropriate in the context of section 13 of the BHC Act and the proposed rule with respect to liquid markets? If not, why not?

Question [•]. Do the proposed indicia of market making in illiquid markets accurately reflect the factors that should generally be used to analyze whether a banking entity is engaged in market making-related activities for purposes of section 13 of the BHC Act and the proposed rule? If not, why not? Should any of the proposed factors be eliminated or modified? Should any additional factors be included?

Question [•]. How accurately can a banking entity predict the near-term demands of clients, customers, and counterparties? Are there measures that can distinguish the amount of principal risk that should be retained to support such near-term client, customer, or counterparty demand from positions taken for speculative purposes? How is client, customer, or counterparty demand anticipated in connection with market making-related activities, and how does such approach vary by asset class?

Question [•]. Is the requirement that a banking entity relying on the market-making exemption be registered as a dealer (or in the case of a financial institution that is a government securities dealer, has filed notice of that status as required by section 15C(a)(1)(B) of the Exchange Act), or exempt from registration or excluded from regulation as a dealer under relevant securities or commodities laws effective? If not, how should the requirement be changed? Does the requirement appropriately take into account the particular registration requirements applicable to dealing in different types of financial instruments? If not, how could it better do so? Does the requirement appropriately take into account the various registration exemptions and exclusions available to certain entities, such as banks, under the securities and commodities laws? If not, how could it better do so?

Question [•]. Is the requirement that a trading desk or other organizational unit of a banking entity relying on the market-making exemption be designed to generate revenues primarily from fees, commissions, bid/ask spreads or similar income effective? If not, how should the requirement be changed? Does the requirement appropriately capture the type and nature of revenues typically generated by market making-related activities? Is any further clarification or additional guidance necessary? Can revenues primarily from fees, commissions, bid/ask spreads or similar income be meaningfully separated from other types of revenues?

Question [•]. Is the requirement that the compensation arrangements of persons performing market making-related activities at a banking entity not be designed to encourage proprietary risk-taking effective? If not, how should the requirement be changed? Are there other types of compensation incentives that should be clearly referenced as consistent, or inconsistent, with permitted market making-related activity? Are their specific and identifiable characteristics of compensation arrangements that clearly incentivize prohibited proprietary trading?

Question [•]. Is the inclusion of market making-related hedging transactions within the market-making exemption effective and appropriate? Are the proposed requirements that certain hedging transactions must meet in order to be considered to have been made in connection with market making-related activity effective and sufficiently clear? If not, what alternative requirements would be more effective and/or clearer? Should any of the proposed requirements be eliminated? If so, which ones, and why?

Question [•]. Should the terms “client,” “customer,” or “counterparty” be defined for purposes of the market-making exemption? If so, how should these terms be defined? For example, would an appropriate definition of “customer” be (i) a continuing relationship in which the banking entity provides one or more financial products or services prior to the time of the transaction, (ii) a direct and substantive relationship between the banking entity and a prospective customer prior to the transaction, or (iii) a relationship initiated by the banking entity to a prospective customer to induce transactions, or (iv) a relationship initiated by the prospective customer with a view to engaging in transactions?

Question [•]. Are there other types of market making-related activities that should also be included within the scope of the market-making exemption? If so, what additional activities and why? How would an exemption for such additional activities be consistent with the language and intent of section 13 of the BHC Act? What criteria, requirements, or restrictions

would be appropriate to include with respect to such additional activities? How would such criteria, requirements, or restrictions prevent circumvention or evasion of the prohibition on proprietary trading?

Question [•]. Do banking entities currently have processes in place that would prevent or reduce the likelihood of taking speculative, proprietary positions in the context of, or mischaracterized as, market making-related activities? If so, what processes?

3. Section __.5: Permitted risk-mitigating hedging activities.

Section __.5 of the proposed rule permits a banking entity to purchase or sell a covered financial position if the transaction is made in connection with, and related to, individual or aggregated positions, contracts, or other holdings of a banking entity and is designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings (the “hedging exemption”). This section of the proposed rule implements, in relevant part, section 13(d)(1)(C) of the BHC Act, which provides an exemption from the prohibition on proprietary trading for certain risk-mitigating hedging activities.

a. Approach to implementing the hedging exemption.

Like market making-related activities, risk-mitigating hedging activities present certain implementation challenges because of the potential that prohibited proprietary trading could be conducted in the context of, or mischaracterized as, a hedging transaction. This is because it may often be difficult to identify in retrospect whether a banking entity engaged in a particular transaction to manage or eliminate risks arising from related positions, on the one hand, or to profit from price movements related to the hedge position itself, on the other. The intent with which a purported hedge position is acquired may often be difficult to discern in practice.

In light of these complexities, the Agencies have again proposed a multi-faceted approach to implementation. As with the underwriting and market-making exemptions, the Agencies have proposed a set of criteria that must be met in order for a banking entity to rely on the hedging exemption. The proposed criteria are intended to define the scope of permitted risk-mitigating hedging activities and to foreclose reliance on the exemption for prohibited proprietary trading that is conducted in the context of, or mischaracterized as, permitted hedging activity. This includes implementation of the programmatic compliance regime required under subpart D of the proposed rule and, in particular, requires that a banking entity with significant trading activities implement robust, detailed hedging policies and procedures and related internal controls that are designed to prevent prohibited proprietary trading in the context of permitted hedging activity.¹⁵⁵ In particular, a banking entity’s compliance regime must include written hedging policies at the trading unit level and clearly articulated trader mandates for each trader to ensure that the decision of when and how to put on a hedge is consistent with such policies and mandates, and not fully left to a trader’s discretion.¹⁵⁶ In addition, to address potential

¹⁵⁵ These aspects of the compliance program requirement are described in further detail in Part III.D of this Supplementary Information.

¹⁵⁶ See, e.g., proposed rule Appendix C.II.a.

supervisory concerns raised by certain types of hedging transactions, § __.5 of the proposed rule also requires a banking entity to document certain hedging transactions at the time the hedge is established. This multi-faceted approach is intended to articulate the Agencies' expectations regarding the scope of permitted risk-mitigating hedging activities in a manner that limits potential abuse of the hedging exemption while not unduly constraining the important risk management function that is served by a banking entity's hedging activities.

b. Required criteria for permitted risk-mitigating hedging activities.

Section __.5(b) of the proposed rule describes the seven criteria that a banking entity must meet in order to rely on the hedging exemption. First, § __.5(b)(1) of the proposed rule requires the banking entity to have established an internal compliance program, consistent with the requirements of subpart D, that is designed to ensure the banking entity's compliance with the requirements of this paragraph, including reasonably-designed written policies and procedures, internal controls, and independent testing. This criterion is intended to ensure that any banking entity relying on the exemption has appropriate internal control processes in place to support its compliance with the terms of the exemption.

Second, § __.5(b)(2)(i) of the proposed rule requires that a transaction for which a banking entity is relying on the hedging exemption have been made in accordance with written policies, procedures and internal controls established by the banking entity pursuant to subpart D. This criterion would preclude reliance on the hedging exemption if the transaction was inconsistent with a banking entity's own hedging policies and procedures, as such inconsistency would appear to be indicative of prohibited proprietary trading.

Third, § __.5(b)(2)(ii) of the proposed rule requires that the transaction hedge or otherwise mitigate one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity. This criterion implements the essential element of the hedging exemption – i.e., that the transaction be risk-mitigating. Notably, and consistent with the statutory reference to mitigating risks of individual or aggregated positions, this criterion would include the hedging of risks on a portfolio basis. For example, it would include the hedging of one or more specific risks arising from a portfolio of diverse holdings, such as the hedging of the aggregate risk of one or more trading desks. However, in each case, the Agencies would expect that the transaction or series of transactions being used to hedge is, in the aggregate, demonstrably risk-reducing with respect to the positions, contracts, or other holdings that are being hedged. A banking entity relying on the exemption should be prepared to identify the specific position or portfolio of positions that is being hedged and demonstrate that the hedging transaction is risk-reducing in the aggregate, as measured by appropriate risk management tools.

In addition, this criterion would include a series of hedging transactions designed to hedge movements in the price of a portfolio of positions. For example, a banking entity may need to engage in dynamic hedging, which involves rebalancing its current hedge position(s) based on a change in the portfolio resulting from permissible activities or from a change in the price, or other characteristic, of the individual or aggregated positions, contracts, or other

holdings. The Agencies recognize that, in such dynamic hedging, material changes in risk may require a corresponding modification to the banking entity's current hedge positions.¹⁵⁷

The Agencies also expect that a banking entity relying on the exemption would be able to demonstrate that the banking entity is already exposed to the specific risks being hedged; generally, the purported hedging of risks to which the banking entity is not actually exposed would not meet the terms of the exemption. However, the hedging exemption would be available in certain cases where the hedge is established slightly before the banking entity becomes exposed to the underlying risk if such anticipatory hedging activity: (i) is consistent with appropriate risk management practices; (ii) otherwise meets the terms of the hedging exemption; and (iii) does not involve the potential for speculative profit. For example, if a banking entity was contractually obligated, or otherwise highly likely, to become exposed to a particular risk and there was a sound risk management rationale for hedging that risk slightly in advance of actual exposure, the hedging transaction would generally be consistent with the requirement described in § __.5(b)(2)(ii) of the proposed rule.

Fourth, § __.5(b)(2)(iii) of the proposed rule requires that the transaction be reasonably correlated, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the transaction is intended to hedge or otherwise mitigate. A transaction that is only tangentially related to the risks that it purportedly mitigates would appear to be indicative of prohibited proprietary trading. Importantly, the Agencies have not proposed that a transaction relying on the hedging exemption be fully correlated; instead, only reasonable correlation is required.¹⁵⁸ The degree of correlation that may be reasonable will vary depending on the underlying risks and the availability of alternative hedging options – risks that can be easily and cost-effectively hedged with extremely high or near-perfect correlation would typically be expected to be so hedged, whereas other risks may be difficult or impossible to hedge with anything greater than partial correlation. Moreover, it is important to consider the fact that trading positions are often subject to a number of different risks, and some risks may be hedged easily and at low cost but may only account for a small proportion of the total risk in the position.¹⁵⁹ More generally, potential correlation levels between asset classes can differ significantly, and analysis of the reasonableness of correlation would depend on the facts and circumstances of the initial position(s), risk(s) created, liquidity of the instrument, and the legitimacy of the hedge. Regardless of the precise degree of correlation, if the predicted performance of a hedge position during the period that the hedge position and the related position are held would result in a banking entity earning appreciably more profits on the

¹⁵⁷ This corresponding modification to the hedge should also be reasonably correlated to the material changes in risk that are intended to be hedged or otherwise mitigated, as required by proposed rule § __.5(b)(2)(iii).

¹⁵⁸ Although certain accounting standards, such as FASB ASC Topic 815 hedge accounting, address circumstances in which a transaction may be considered a hedge of another transaction, the proposed rule does not refer to or rely on these accounting standards, because such standards (i) are designed for financial statement purposes, not to identify proprietary trading and (ii) change often and are likely to change in the future without consideration of the potential impact on section 13 of the BHC Act.

¹⁵⁹ Interest rate risk in an equity derivative transaction is one example – the hedging of interest rate risk in an equity derivative position may only result in a small reduction in overall risk and interest rates may only exhibit a small correlation with the value of the equity derivative, but the lack of perfect or significant correlation would not impair reliance on the hedging exemption.

hedge position than it stood to lose on the related position, the hedge would appear likely to be a proprietary trade designed to result in profit rather than an exempt hedge position.

Fifth, § __.5(b)(2)(iv) of the proposed rule requires that the hedging transaction not give rise, at the inception of the hedge, to significant exposures that are not themselves hedged in a contemporaneous transaction. A transaction that creates significant new risk exposure that is not itself hedged at the same time would appear to be indicative of prohibited proprietary trading. For example, over-hedging, correlation trading, or pairs trading strategies that generate profits through speculative, proprietary risk-taking would fail to meet this criterion. Similarly, a transaction involving a pair of positions that hedge each other with respect to one type of risk exposure, but create or contain a residual risk exposure would, taken together, constitute prohibited proprietary trading and not risk-mitigating hedging if those positions were taken collectively for the purpose of profiting from short-term movements in the effective price of the residual risk exposure. However, the proposal also recognizes that any hedging transaction will inevitably give rise to certain types of new risk, such as counterparty credit risk or basis risk reflecting the differences between the hedge position and the related position; the proposed criterion only prohibits the introduction of additional significant exposures through the hedging transaction. In addition, proposed § __.5(b)(2)(iv) only requires that no new and significant exposures be introduced at the inception of the hedge, and not during the entire period that the hedge is maintained, reflecting the fact that new, unanticipated risks can and sometimes do arise out of hedging positions after the hedge is established. The Agencies have proposed to address the appropriate management of risks that arise out of a hedge position after inception through § __.5(b)(2)(v) of the proposed rule.

Sixth, § __.5(b)(2)(v) of the proposed rule requires that any transaction conducted in reliance on the hedging exemption be subject to continuing review, monitoring and management after the hedge position is established. Such review, monitoring, and management must: (i) be consistent with the banking entity's written hedging policies and procedures; (ii) maintain a reasonable level of correlation, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate; and (iii) mitigate any significant exposure arising out of the hedge after inception. In accordance with a banking entity's written internal hedging policies, procedures, and internal controls, a banking entity should actively review and manage its hedging positions and the risks that may arise out of those positions over time. A banking entity's internal hedging policies should be designed to ensure that hedges remain effective as correlations or other factors change. In particular, a risk-mitigating hedge position typically should be unwound as exposure to the underlying risk is reduced or increased as underlying risk increases, as selective hedging activity would appear to be indicative of prohibited proprietary trading.¹⁶⁰ A banking entity's written internal hedging policies, procedures, and internal controls for monitoring and managing its hedges also should be reasonably designed to prevent the occurrence of such prohibited proprietary trading activity and

¹⁶⁰ The Agencies note that in some cases, it may be appropriate for a banking entity to unwind a hedge, even if the underlying risk remains, if the cost of that hedge become uneconomic, better hedging options become available, or the overall risk profile of the banking entity has changed such that no longer hedging the risk is consistent with appropriate risk management practices.

be reasonably specific about the level of hedging that is expected to be maintained regardless of opportunities for profit associated with over- or under-hedging.

Seventh, § __.5(b)(2)(vi) of the proposed rule requires that the compensation arrangements of persons performing the risk-mitigating hedging activities are designed not to reward proprietary risk-taking. Hedging activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a covered financial position, rather than success in reducing risk, are inconsistent with permitted risk-mitigating hedging activities.

c. Documentation requirement.

Section __.5(c) of the proposed rule imposes a documentation requirement on certain types of hedging transactions. Specifically, for any transaction that a banking entity conducts in reliance on the hedging exemption that involves a hedge established at a level of organization that is different than the level of organization establishing the positions, contracts, or other holdings the risks of which the hedging transaction is designed to reduce, the banking entity must, at a minimum, document the risk-mitigating purpose of the transaction and identify the risks of the individual or aggregated positions, contracts, or other holdings of a banking entity that the transaction is designed to reduce.¹⁶¹ Such documentation must be established at the time the hedging transaction is effected, not after the fact. The Agencies are concerned that hedging transactions established at a different level of organization than the positions being hedged may present or reflect heightened potential for prohibited proprietary trading, as a banking entity may be able, after the fact, to point to a particular, offsetting exposure within its organization after a position is established and characterize that position as a hedge even when, at the time the position was established, it was intended to generate speculative proprietary gains, not mitigate risk. To address this concern, the Agencies have proposed to require a banking entity, when establishing a hedge at a different level of organization than that establishing or responsible for the underlying positions or risks being hedged, to document the hedging purpose of the transaction and risks being hedged so as to establish a contemporaneous, documentary record that will assist the Agencies in assessing the actual reasons for which the position was established.

d. Request for comment.

The Agencies request comment on the proposed implementation of the risk-mitigating hedging exemption with respect to proprietary trading. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule's approach to implementing the hedging exemption effective? If not, what alternative approach would be more effective?

¹⁶¹ For example, a hedge would be established at a different level of organization of the banking entity if multiple market making desks were exposed to similar risks and, to hedge such risks, a portfolio hedge was established at the direction of a supervisor or risk manager responsible for more than one desk rather than at each of the market making desks that established the initial positions, contracts, or other holdings.

Question [•]. Does the proposed multi-faceted approach appropriately take into account and address the challenges associated with differentiating prohibited proprietary trading from permitted hedging activities? Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

Question [•]. Does the proposed approach to implementing the hedging exemption provide banking entities and market participants with sufficient clarity regarding what constitutes permitted hedging activities? If not, how could greater clarity be provided?

Question [•]. What impact will the proposed approach to implementing the hedging exemption have on the hedging and risk management activities of a banking entity and the services it provide to its clients? If any of these impacts are positive, how can they be amplified? If any of these impacts are negative, how can they be mitigated?

Question [•]. What burden will the proposed approach to implementing the hedging exemption have on banking entities? How can any burden be minimized or eliminated in a manner consistent with the language and purpose of the statute?

Question [•]. Are the criteria included in the hedging exemption effective? Is the application of each criterion to potential transactions sufficiently clear? Should any of the criteria be changed or eliminated? Should other requirements be added?

Question [•]. Is the requirement that a transaction hedge or otherwise mitigate one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity effective? If not, what requirement would be more effective? Does the proposed approach sufficiently articulate the types of risks that a banking entity typically hedges? Does the proposal sufficiently address application of the hedging exemption to portfolio hedging strategies? If not, how should the proposal be changed?

Question [•]. Does the manner in which section __.5 of the proposal would implement the risk-mitigating hedging exemption effectively address transactions that hedge or otherwise mitigate specific risks arising in connection with and related to aggregated positions, contracts, or other holdings of a banking entity? Do certain hedging strategies or techniques that involve hedging the risks of aggregated positions (e.g., portfolio hedging) (i) create the potential for abuse of the hedging exemption or (ii) give rise to challenges in determining whether a banking entity is engaged in exempt, risk-mitigating hedging activity or prohibited proprietary trading? If so, what hedging strategies and techniques, and how? Should additional restrictions, conditions, or requirements be placed on the use of the hedging exemption with respect to aggregated positions so as to limit potential abuse of the exemption, assist banking entities and the Agencies in determining compliance with the exemption, or otherwise improve the effectiveness of the rule? If so, what additional restrictions, conditions, or requirements, and why?

Question [•]. Is the requirement that the transaction be reasonably correlated to the risk or risks the transaction is intended to hedge or otherwise mitigate effective? If not, how should the requirement be changed? Should some specific level of correlation and/or hedge

effectiveness be required? Should the proposal specify in greater detail how correlation should be measured? Should the proposal require hedges to be effective in periods of financial stress? Does the proposal sufficiently reflect differences in levels of correlation among asset classes? If not, how could it better do so?

Question [•]. Is the requirement that the transaction not give rise, at the inception of the hedge, to significant exposures that are not themselves hedged in a contemporaneous transaction effective? Does the requirement establish an appropriate range for legitimate hedging while constraining impermissible proprietary trading? Is this requirement sufficiently clear? If not, what alternative would be more effective and/or clearer? Are there types of risk-mitigating hedging activities that may give rise to new and significant exposures that should be permitted under the hedging exemption? If so, what activities? Should the requirement that no significant exposure be introduced be extended for the duration of the hedging position? If so, why?

Question [•]. Is the requirement that any transaction conducted in reliance on the hedging exemption be subject to continuing review, monitoring and management after the transaction is established effective? If not, what alternative would be more effective?

Question [•]. Is the requirement that the compensation arrangements of persons performing risk-mitigating hedging activities at a banking entity be designed not to reward proprietary risk-taking effective? If not, how should the requirement be changed? Are there other types of compensation incentives that should be clearly referenced as consistent, or inconsistent, with permitted risk-mitigating hedging activity? Are there specific and identifiable characteristics of compensation arrangements that clearly incentivize prohibited proprietary trading?

Question [•]. Is the proposed documentation requirement effective? If not, what alternative would be more effective? Are there certain additional types of hedging transactions that should be subject to the documentation requirement? If so, what transactions and why? Should all types of hedging transactions be subject to the documentation requirement? If so, why? Should banking entities be required to document more aspects of a particular transactions (e.g., all of the criteria applicable to § __.5(b) of the proposed rule)? If so, what aspects and why? What burden would the proposed documentation requirement place on banking entities? How might such burden be reduced or eliminated in a manner consistent with the language and purpose of the statute?

Question [•]. Aside from the required documentation, do the substantive requirements of the proposed risk-mitigating hedging exemption suggest that additional documentation would be required to achieve compliance with the proposed rule? If so, what burden would this additional documentation requirement place on banking entities? How might such burden be reduced or eliminated in a manner consistent with the language and purpose of the statute?

4. Section __.6: Other permitted trading activities.

Section __.6 of the proposed rule permits a banking entity to engage in certain other trading activities described in section 13(d)(1) of the BHC Act. These permitted activities include trading in certain government obligations, trading on behalf of customers, trading by

insurance companies, and trading outside of the United States by certain foreign banking entities. Section __.6 of the proposed rule does not contain all of the statutory exemptions contained in section 13(d)(1) of the BHC Act. Several of these exemptions appear, either by plain language or by implication, to be intended to apply only to covered fund activities and investments, and so the Agencies have not proposed to include them in the proposed rule's proprietary trading provisions.¹⁶² Those exemptions are referenced in other portions of the proposed rule pertaining to covered funds.

The Agencies request comment on the proposed rule's approach to implementing the exemptions contained in section 13(d)(1) of the BHC Act to the proposed rule's proprietary trading provisions. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule's approach of identifying which of the statutory exemptions contained in section 13(d)(1) of the BHC Act apply to the proposed rule's proprietary trading provisions effective and/or consistent the language and purpose of the statute? If not, what alternative would be more effective and/or consistent with the language and purpose of the statute?

Question [•]. Are there statutory exemptions that should apply to the proposed rule's proprietary trading provisions that were not included? If so, what exemptions and why?

Question [•]. Are there statutory exemptions that were included in the proposed rule's proprietary trading provisions that should not have been included? If so, what exemptions and why?

a. Permitted trading in government obligations.

Section __.6(a) of the proposed rule, which implements section 13(d)(1)(A) of the BHC Act,¹⁶³ permits the purchase or sale of a covered financial position that is: (i) an obligation of the United States or any agency thereof;¹⁶⁴ (ii) an obligation, participation, or other instrument of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 et seq.); or (iii) an

¹⁶² In particular, the proposed rule does not apply (i) the exemption in section 13(d)(1)(E) of the BHC Act for SBICs and certain public welfare or qualified rehabilitation investments, or (ii) the exemptions in sections 13(d)(1)(G) and 13(d)(1)(I) of the BHC Act for certain covered funds activities and investments, to the proprietary trading provisions of subpart B.

¹⁶³ Section 13(d)(1)(A) of the BHC Act permits a banking entity to purchase, sell, acquire or dispose securities and other instruments described in section 13(h)(4) of the BHC Act if those securities or other instruments are specified types of government obligations, notwithstanding the prohibition on proprietary trading. See 12 U.S.C. 1851(d)(1)(A).

¹⁶⁴ The Agencies propose that United States "agencies" for this purpose will include those agencies described in section 201.108(b) of the Board's Regulation A. See 12 CFR 201.108(b). The Agencies also note that the terms of the exemption would encompass the purchase or sale of enumerated government obligations on a forward basis (e.g., in a to-be-announced market).

obligation issued by any State or any political subdivision thereof.¹⁶⁵ The proposed rule also clarifies that these obligations include limited as well as general obligations of the relevant government entity. The Agencies note that, consistent with the statutory language, the types of instruments described with respect to the enumerated government-sponsored entities include not only obligations of such entities, but also participations and other instruments of or issued by such entity. This would include, for example, pass-through or participation certificates that are issued and guaranteed by one of these government-sponsored entities (e.g., the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation) in connection with their securitization activities.

The Agencies request comment on the proposed rule's approach to implementing the government obligation exemption. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule's application to trading in government obligations sufficiently clear? Should such obligations expressly include, for example, instruments issued by third parties but insured or guaranteed by an enumerated government entity or otherwise backed by its full faith and credit?

Question [•]. Should the Agencies adopt an additional exemption for proprietary trading in State or municipal agency obligations under section 13(d)(1)(J) of the BHC Act? If so, how would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?

Question [•]. Should the Agencies adopt an additional exemption for proprietary trading in options or other derivatives referencing an enumerated government obligation under section 13(d)(1)(J) of the BHC Act? For example, should the Agencies provide an exemption for options or other derivatives with respect to U.S. government debt obligations? If so, how would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?

Question [•]. Should the Agencies adopt an additional exemption for proprietary trading in the obligations of foreign governments and/or international and multinational development banks under section 13(d)(1)(J) of the BHC Act? If so, what types of obligations should be exempt? How would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?

Question [•]. Should the Agencies adopt an additional exemption for proprietary trading in any other type of government obligations under section 13(d)(1)(J) of the BHC Act? If so, how would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?

Question [•]. Are the definitions of "government security" and "municipal security" in sections 3(a)(42) and 3(a)(29) of the Exchange Act helpful in determining the proper scope of

¹⁶⁵ Consistent with the statutory language, the proposed rule does not extend the government obligations exemption to transactions in obligations of an agency of any State or political subdivision thereof.

this exemption? If so, please explain their utility and how incorporating such definitions into the exemption would be consistent with the language and purpose of section 13 of the BHC Act.

b. Permitted trading on behalf of customers.

Section 13(d)(1)(D) of the BHC Act permits a banking entity to purchase or sell a covered financial position on behalf of customers, notwithstanding the prohibition on proprietary trading. Section __.6(b) of the proposed rule implements this section. Because the statute does not specifically define when a transaction would be conducted “on behalf of customers,” the proposed rule identifies three categories of transactions that, while they may involve a banking entity acting as principal for certain purposes, appear to be on behalf of customers within the purpose and meaning of the statute. As proposed, only transactions meeting the terms of these three categories would be considered on behalf of customers for purposes of the exemption.

Section __.6(b)(i) of the proposed rule provides that a purchase or sale of a covered financial position is on behalf of customers if the transaction (i) is conducted by a banking entity acting as investment adviser, commodity trading advisor, trustee, or in a similar fiduciary capacity for a customer and for the account of that customer, and (ii) involves solely covered financial positions of which the banking entity’s customer, and not the banking entity or any subsidiary or affiliate of the banking entity, is beneficial owner (including as a result of having long or short exposure under the relevant covered financial position). This category is intended to capture a wide range of trading activity conducted in the context of customer-driven investment or commodity advisory, trust, or fiduciary services, so long as that activity is structured in a way that the customer, and not the banking entity providing those services, benefits from any gains and suffers from any losses on such covered financial positions.¹⁶⁶ A transaction that is structured so as to involve a listed form of relationship but nonetheless allows gains or losses from trading activity to inure to the benefit or detriment of the banking entity would fall outside the scope of this category.

Section __.6(b)(ii) of the proposed rule provides that a transaction is on behalf of customers if the banking entity is acting as riskless principal. These type of transactions are similarly customer-driven and do not expose the banking entity to gains or losses on the value of the traded positions, notwithstanding the fact that the banking entity technically acts as principal. The Agencies note that the proposed language describing riskless principal transactions generally mirrors that used in the Board’s Regulation Y, OCC interpretive letters, and the SEC’s Rule 3a5-1 under the Exchange Act.¹⁶⁷

Section __.6(b)(iii) of the proposed rule addresses trading for the separate account of insurance policyholders by a banking entity that is an insurance company. In particular, this part of the proposed rule provides that a purchase or sale of a covered financial position is on behalf of customers if:

¹⁶⁶ For example, in the case of a banking entity acting as investment adviser to a registered mutual fund, any trading by the banking entity in its capacity of investment adviser and on behalf of that fund would be permitted pursuant to § __.6(b)(i) of the proposed rule, so long as the relevant criteria were met.

¹⁶⁷ See 12 CFR 225.28(b)(7)(ii); 17 CFR 240.3a5-1(b); OCC Interpretive Letter 626 (July 7, 1993).

- The banking entity is an insurance company engaging in the transaction for a separate account;
- The banking entity is directly engaged in the business of insurance and subject to regulation by a State insurance regulator or foreign insurance regulator;¹⁶⁸
- The banking entity purchases or sells the covered financial position solely for a separate account established by the insurance company in connection with one or more insurance policies issued by that insurance company;
- All profits and losses arising from the purchase or sale of the covered financial position are allocated to the separate account and inure to the benefit or detriment of the owners of the insurance policies supported by the separate account, and not the banking entity; and
- The purchase or sale is conducted in compliance with, and subject to, the insurance company investment and other laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled.

This category is included within the exemption for transactions on behalf of customers because such insurance-related transactions are generally customer-driven and do not expose the banking entity to gains or losses on the value of separate account assets, even though the banking entity may be treated as the owner of those assets for certain purposes. However, to limit the potential for abuse of the exemption, the proposed rule also includes related requirements designed to ensure that the separate account trading activity is subject to appropriate regulation and supervision under insurance laws and not structured so as to allow gains or losses from trading activity to inure to the benefit or detriment of the banking entity.¹⁶⁹ The proposed rule defines a “separate account” as an account established or maintained by a regulated insurance company subject to regulation by a State insurance regulator or foreign insurance regulator under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.¹⁷⁰

The Agencies request comment on the proposed rule’s approach to implementing the exemption for trading on behalf of customers. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule’s articulation of three categories of transactions on behalf of customers effective and sufficiently clear? If not, what alternative would be more

¹⁶⁸ The proposed rule provides definitions of the terms “State insurance regulator” and “foreign insurance regulator.” See proposed rule §§ __.3(c)(4), (13).

¹⁶⁹ The Agencies would not consider profits to inure to the benefit of the banking entity if the banking entity were solely to receive payment, out of separate account profits, of fees unrelated to the investment performance of the separate account.

¹⁷⁰ See proposed rule § __.2(z).

effective and/or clearer? Should any of the categories be eliminated? Should any additional categories be added? Please explain.

Question [•]. Is the proposed rule's exemption of certain investment adviser, commodity trading advisor, trustee or similar fiduciary transactions effective? What other types of relationships are or should be captured by the proposed rule's reference to "similar fiduciary relationships," and why? Is application of this part of the exemption to particular transactions sufficiently clear? Should any other specific types of fiduciary or other relationships be specified in the rule? If so, what types and why? What impact will the proposed rule's implementation of the exemption have on the investment adviser, commodity trading advisor, trustee or similar fiduciary activities of banking entities? If such impacts are negative, how could they be mitigated or eliminated in a manner consistent with the purpose and language of the statute?

Question [•]. Is the proposed rule's exemption of riskless principal transactions effective? If not, what alternative would be more appropriate? Is the description of qualifying riskless principal activity sufficiently clear? If not, how should it be clarified? Should the riskless principal transaction exemption include a requirement that the banking entity must purchase (or sell) the covered financial position as principal at the same price to satisfy the customer buy (or sell) order, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee? Why or why not? Should the riskless principal exemption include a requirement with respect to the timeframe in which the principal transaction must be allocated to a riskless principal or customer account? Why or why not?

Question [•]. Is the proposed rule's exemption of trading for separate accounts by insurance companies effective? If not, what alternative would be more appropriate? Does the proposed exemption sufficiently address the variety of customer-driven separate account structures typically used? If not, how should it address such structures? Does the proposed exemption sufficiently address the variety of regulatory or supervisory regimes to which insurance companies may be subject?

Question [•]. What impact will the proposed rule's implementation of the exemption have on the insurance activities of insurance companies affiliated with banking entities? If such impacts are negative, how could they be mitigated or eliminated in a manner consistent with the purpose and language of the statute?

Question [•]. Should the term "customer" be defined for purposes of the exemption for transactions of behalf of customers? If so, how should it be defined? For example, would an appropriate definition be (i) a continuing relationship in which the banking entity provides one or more financial products or services prior to the time of the transaction, (ii) a direct and substantive relationship between the banking entity and a prospective customer prior to the transaction, or (iii) a relationship initiated by the banking entity to a prospective customer for purposes of the transaction?

Question [•]. Is the exemption for trading on behalf of customers in the proposed rule over- or under-inclusive? If it is under-inclusive, please discuss any additional activities that should qualify as trading on behalf of customers under the rule. What are the mechanics of the particular trading activity and how does it qualify as being on behalf of customers? Are there

certain requirements or restrictions that should be placed on the activity, if permitted by the rule, to prevent evasion of the prohibition on proprietary trading? How would permitting the activity be consistent with the purpose and language of section 13 of the BHC Act? If the proposed exemption is over-inclusive, please explain what aspect of the proposed exemption does not involve trading on behalf of customers within the language and purpose of the statute.

c. Permitted trading by a regulated insurance company.

Section __.6(c) of the proposed rule implements section 13(d)(1)(F) of the BHC Act,¹⁷¹ which permits a banking entity to purchase or sell a covered financial position if the banking entity is a regulated insurance company acting for its general account or an affiliate of an insurance company acting for the insurance company's general account, subject to certain conditions. Section __.6(d) of the proposed rule generally restates the statutory requirements of the exemption, which provide that:

- The insurance company must directly engage in the business of insurance and be subject to regulation by a State insurance regulator or foreign insurance regulator;
- The insurance company or its affiliate must purchase or sell the covered financial position solely for the general account of the insurance company;
- The purchase or sale must be conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled; and
- The appropriate Federal banking agencies, after consultation with the Council and the relevant insurance commissioners of the States, must not have jointly determined, after notice and comment, that a particular law, regulation, or written guidance described above is insufficient to protect the safety and soundness of the banking entity or of the financial stability of the United States.¹⁷²

The proposed rule defines a “general account” as all of the assets of the insurance company that are not legally segregated and allocated to separate accounts under applicable State law.¹⁷³

The Agencies request comment on the proposed rule's approach to implementing the exemption for general account trading by insurance companies. In particular, the Agencies request comment on the following questions:

¹⁷¹ See 12 U.S.C. 1851(d)(1)(F).

¹⁷² The Federal banking agencies have not proposed at this time to determine, as part of the proposed rule, that the insurance company investment laws, regulations, and written guidance of any particular State or jurisdiction are insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States. The Federal banking agencies expect to monitor, in conjunction with the Federal Insurance Office established under section 502 of the Dodd-Frank Act, the insurance company investment laws, regulations, and written guidance of States or jurisdictions to which exempt transactions are subject and make such determinations in the future, where appropriate.

¹⁷³ See proposed rule § __.3(c)(6).

Question [•]. Should any of the statutory requirements for the exemption be further clarified in the proposed rule? If so, how? Should any additional requirements be added? If so, what requirements and why?

Question [•]. Does the proposed rule appropriately and clearly define a general account for these purposes? If not, what alternative definition would be more appropriate?

Question [•]. For purposes of the exemption, are the insurance company investment laws, regulations, and written guidance of any particular State or jurisdiction insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States? If so, why?

Question [•]. What impact will the proposed rule's implementation of the exemption have on the insurance activities of insurance companies affiliated with banking entities? If such impacts are negative, how could they be mitigated or eliminated in a manner consistent with the purpose and language of the statute?

d. Permitted trading outside of the United States.

Section __.6(d) of the proposed rule implements section 13(d)(1)(H) of the BHC Act,¹⁷⁴ which permits certain foreign banking entities to engage in proprietary trading that occurs solely outside of the United States. This statutory exemption limits the extraterritorial application of the prohibition on proprietary trading to the foreign activities of foreign firms, while preserving national treatment and competitive equality among U.S. and foreign firms within the United States. Consistent with the statute, the proposed rule defines both the type of foreign banking entities that are eligible for the exemption and the circumstances in which proprietary trading by such an entity will be considered to have occurred solely outside of the United States.

i. Foreign banking entities eligible for the exemption.

Section __.6(d)(1)(i) of the proposed rule provides that, in order to be eligible for the foreign trading exemption, the banking entity must not be directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. This requirement limits the scope of the exemption to banking entities that are organized under foreign law and controlled only by entities organized under foreign law. Consistent with the statutory language, a banking entity organized under the laws of the United States or any State and the subsidiaries and branches of such banking entity (wherever organized or licensed) may not rely on the exemption.¹⁷⁵ Similarly, a U.S. subsidiary or branch of a foreign banking entity would not qualify for the exemption.

¹⁷⁴ Section 13(d)(1)(H) of the BHC Act permits a banking entity to engage in proprietary trading, notwithstanding the prohibition on proprietary trading, if it is conducted by a banking entity pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act and the trading occurs solely outside of the United States and the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. See 12 U.S.C. 1851(d)(1)(H).

¹⁷⁵ Under the proposal, a "State" means any State, territory or possession of the United States, and the District of Columbia. See proposed rule § __.2(aa).

Section __.6(d)(1)(ii) of the proposed rule incorporates the statutory requirement that the banking entity must also conduct the transaction pursuant to sections 4(c)(9) or 4(c)(13) of the BHC Act. Section __.6(d)(2) clarifies when a banking entity would meet that requirement, the criteria for which vary depending on whether or not the banking entity is a foreign banking organization.¹⁷⁶

Section 4(c)(9) of the BHC Act provides that the restrictions on interests in nonbanking organizations contained in that statute do not apply to the ownership of shares held or activities conducted by any company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States, if the Board by regulation or order determines that, under the circumstances and subject to the conditions set forth in the regulation or order, the exemption would not be substantially at variance with the purposes of the BHC Act and would be in the public interest.¹⁷⁷ The Board has implemented section 4(c)(9) as part of subpart B of the Board's Regulation K,¹⁷⁸ which specifies a number of conditions and requirements that a foreign banking organization must meet in order to use such authority. Such conditions and requirements include, for example, a qualifying foreign banking organization test that requires the foreign banking organization to demonstrate that more than half of its worldwide business is banking and that more than half of its banking business is outside the United States. The proposed rule makes clear that if a banking entity is a foreign banking organization, it will qualify for the foreign trading exemption if the entity is a qualifying foreign banking organization that conducts the transaction in compliance with subpart B of the Board's Regulation K, and the transaction occurs solely outside of the United States.

Section 13 of the BHC Act also applies to foreign companies that control a U.S. insured depository institution but are not currently subject to the BHC Act generally or to the Board's Regulation K – for example, because the foreign company controls a savings association or an FDIC-insured industrial loan company. Accordingly, the proposed rule also clarifies when this type of foreign banking entity would be considered to have conducted a transaction “pursuant to section 4(c)(9)” for purposes of the foreign trading exemption.¹⁷⁹ In particular, the draft rule proposes that to qualify for the foreign trading exemption, such firms must meet at least two of three requirements that evaluate the extent to which the foreign entity's business is conducted outside the United States, as measured by assets, revenues, and income. This test largely mirrors the qualifying foreign banking organization test that is made applicable under section 4(c)(9) of the BHC Act and § 211.23(a) of the Board's Regulation K, except that the test does not also

¹⁷⁶ Section __.6(d)(2) only addresses when a transaction will be considered to have been conducted pursuant to section 4(c)(9) of the BHC Act. Although the statute also references section 4(c)(13) of the BHC Act, the Board has applied the authority contained in that section solely to the foreign activities of U.S. banking organizations which, by the express terms of section 13(d)(1)(H) of the BHC Act, are unable to rely on the foreign trading exemption.

¹⁷⁷ See 12 U.S.C. 1843(c)(9).

¹⁷⁸ See 12 CFR 211.20 *et seq.*

¹⁷⁹ The Board emphasizes that this clarification would be applicable solely in the context of section 13(d)(1) of the BHC Act. The application of section 4(c)(9) to foreign companies in other contexts is likely to involve different legal and policy issues and may therefore merit different approaches.

require such a foreign entity to demonstrate that more than half of its banking business is outside the United States.¹⁸⁰

ii. Trading solely outside of the United States.

The proposed rule also clarifies when a transaction will be considered to have occurred solely outside of the United States for purposes of the exemption. In interpreting this aspect of the statutory language, the proposal focuses on the extent to which material elements of the transaction occur within, or are conducted by personnel within, the United States. This focus seeks to avoid extraterritorial application of the prohibition of proprietary trading outside the United States while preserving competitive parity within U.S. markets. The proposed rule does not evaluate solely whether the risk of the transaction or management or decision-making with respect to the transaction rests outside the United States, as such an approach would appear to permit foreign banking entities to structure transactions so as to be “outside of the United States” for risk and booking purposes while engaging in transactions within U.S. markets that are prohibited for U.S. banking entities.

In particular, § __.6(d)(3) of the proposed rule provides that a transaction will be considered to have occurred solely outside of the United States only if four conditions are met:

- The transaction is conducted by a banking entity that is not organized under the laws of the United States or of one or more States;
- No party to the transaction is a resident of the United States;
- No personnel of the banking entity that is directly involved in the transaction is physically located in the United States;¹⁸¹ and
- The transaction is executed wholly outside the United States.

These four criteria are intended to ensure that a transaction executed in reliance on the exemption does not involve U.S. counterparties, U.S. trading personnel, U.S. execution facilities, or risks retained in the United States. The presence of any of these factors would appear to constitute a sufficient locus of activity in the U.S. marketplace so as to preclude availability of the exemption.

A resident of the United States is defined in § __.2(t) of the proposed rule, and includes: (i) any natural person resident in the United States; (ii) any partnership, corporation or other business entity organized or incorporated under the laws of the United States or any State; (iii)

¹⁸⁰ See 12 U.S.C. 1843(c)(9); 12 CFR 211.23(a); proposed rule § __.6(d)(2). This difference reflects the fact that foreign entities subject to section 13 of the BHC Act, but not the BHC Act generally, are likely to be, in many cases, predominantly commercial firms. A requirement that such firms also demonstrate that more than half of their banking business is outside the United States would likely make the exemption unavailable to such firms and subject their global activities to the prohibition on proprietary trading, a result that the statute does not appear to have intended.

¹⁸¹ Personnel directly involved in the transaction would generally not include persons performing purely administrative, clerical, or ministerial functions.

any estate of which any executor or administrator is a resident of the United States; (iv) any trust of which any trustee, beneficiary or, if the trust is revocable, settlor is a resident of the United States; (v) any agency or branch of a foreign entity located in the United States; (vi) any discretionary or non-discretionary account or similar account (other than an estate or trust) held by a dealer or fiduciary for the benefit or account of a resident of the United States; (vii) any discretionary account or similar account (other than an estate or trust) held by a dealer or fiduciary organized or incorporated in the United States, or (if an individual) a resident of the United States; or (viii) any partnership or corporation organized or incorporated under the laws of any foreign jurisdiction formed by or for a resident of the United States principally for the purpose of engaging in one or more transactions described in § __.6(d)(1) or § __.13(c)(1) of the proposed rule.¹⁸² The proposed definition is designed to capture the scope of U.S. counterparties, decision-makers and personnel that, if involved in the transaction, would preclude that transaction from being considered to have occurred solely outside the United States. The Agencies note that the proposed definition is similar but not identical to the definition of “U.S. person” for purposes of the SEC’s Regulation S, which governs securities offerings and sales outside of the United States that are not registered under the Securities Act.¹⁸³

iii. Request for comment.

The Agencies request comment on the proposed rule’s approach to implementing the foreign trading exemption. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule’s implementation of the foreign trading exemption effectively delineated? If not, what alternative would be more effective and/or clearer?

Question [•]. Are the proposed rule’s provisions regarding when an activity will be considered to have been conducted pursuant to section 4(c)(9) of the BHC Act effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Do those provisions effectively address the application of the foreign trading exemption to foreign banking entities not subject to the BHC Act generally? If not, how should the proposed rule apply the exemption?

Question [•]. Are the proposed rule’s provisions regarding when an activity will be considered to have occurred solely outside the United States effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should any requirements be modified or removed? If so, which requirements and why? Should additional requirements be added? If so, what requirements and why?

Question [•]. Is the proposed rule’s definition of “resident of the United States” effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Is the definition over- or under-inclusive? If so, why? Should the definition more closely track, or incorporate by reference, the definition of “U.S. person” under the SEC’s Regulation S under the Securities Act? If so, why?

¹⁸² See proposed rule § __.2(t).

¹⁸³ See 17 CFR 230.902(k).

Question [•]. Does the proposed rule effectively define a resident of the United States for these purposes? If not, how should the definition be altered?

Question [•]. Should the Agencies use the authority provided in section 13(d)(1)(J) of the BHC Act to allow U.S.-controlled banking entities to engage in proprietary trading pursuant to section 4(c)(13) of the BHC Act outside of the United States under certain circumstances? If so, under what circumstances should this be permitted and how would such activity promote and protect the safety and soundness of banking entities and the financial stability of the United States?

e. Discretionary Exemptions for Proprietary Trading under Section 13(d)(1)(J) of the BHC Act.

Section 13(d)(1)(J) of the BHC Act permits the Agencies to grant, by rule, other exemptions from the prohibition on proprietary trading if the Agencies determine that the exemption would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.¹⁸⁴ The Agencies have not, at this time, proposed any such discretionary exemptions with respect to the prohibition on proprietary trading. The Agencies request comment as follows:

Question [•]. Should the Agencies adopt any exemption from the prohibition on proprietary trading under section 13(d)(1)(J) of the BHC Act? If so, what exemption and why? How would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?

5. Section __.7: Reporting and recordkeeping requirements applicable to trading activities.

Section __.7 of the proposed rule, which implements in part section 13(e)(1) of the BHC Act,¹⁸⁵ requires certain banking entities to comply with the reporting and recordkeeping requirements specified in Appendix A of the proposed rule. In addition, §__.7 requires banking entities to comply with the recordkeeping requirements in §__.20 of the proposed rule, related to the banking entity's compliance program,¹⁸⁶ as well as any other reporting or recordkeeping requirements that the Agency may impose to evaluate the banking entity's compliance with the proposed rule.¹⁸⁷ Proposed Appendix A requires a banking entity with significant trading activities to furnish periodic reports to the relevant Agency regarding various quantitative measurements of its trading activities and create and retain records documenting the preparation and content of these reports. The measurements vary depending on the scope, type, and size of

¹⁸⁴ See 12 U.S.C. 1851(d)(1)(J). In addition to permitting the Agencies to provide additional exemptions from the prohibition on proprietary trading, section 13(d)(1)(J) also states that the Agencies may provide additional exemptions from the prohibition on investing in or sponsoring a covered fund, as discussed in Part III.C.5 of this Supplementary Information.

¹⁸⁵ Section 13(e)(1) of the BHC Act requires the Agencies to issue regulations regarding internal controls and recordkeeping to ensure compliance with section 13. See 12 U.S.C. 1851(e)(1). Section __.20 and Appendix C of the proposed rule also implement section 13(e)(1) of the BHC Act.

¹⁸⁶ See Supplementary Information, Part III.D.

¹⁸⁷ See proposed rule § __.7.

trading activities. In addition, proposed Appendix B contains a detailed commentary regarding the characteristics of permitted market making-related activities and how such activities may be distinguished from trading activities that, even if conducted in the context of a banking entity's market-making operations, would constitute prohibited proprietary trading.

A banking entity must comply with proposed Appendix A's reporting and recordkeeping requirements only if it has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than \$1 billion.¹⁸⁸ The Agencies have not proposed to extend the reporting and recordkeeping requirements to banking entities with smaller amounts of trading activity, as it appears that the more limited benefits of applying these requirements to such banking entities, whose trading activities are typically small, less complex, and easier to supervise, would not justify the burden associated with complying with the reporting and recordkeeping requirements.

a. General approach to reporting and recordkeeping requirements.

The reporting and recordkeeping requirements of § __.7 and Appendix A of the proposed rule are an important part of the proposed rule's multi-faceted approach to implementing the prohibition on proprietary trading. These requirements are intended, in particular, to address some of the difficulties associated with (i) identifying permitted market making-related activities and distinguishing such activities from prohibited proprietary trading and (ii) identifying certain trading activities resulting in material exposure to high-risk assets or high-risk trading strategies. To do so, the proposed rule requires certain banking entities to calculate and report detailed quantitative measurements of their trading activity, by trading unit. These measurements will help banking entities and the Agencies in assessing whether such trading activity is consistent with permitted trading activities in scope, type and profile. The quantitative measurements that must be reported under the proposed rule are generally designed to reflect, and to provide meaningful information regarding, certain characteristics of trading activities that appear to be particularly useful in differentiating permitted market making-related activities from prohibited proprietary trading. For example, the proposed quantitative measurements measure the size and type of revenues generated, and the types of risks taken, by a trading unit. Each of these measurements appears to be useful in assessing whether a trading unit is (i) engaged in permitted market making-related activity or (ii) materially exposed to high-risk assets or high-risk trading strategies. Similarly, the proposed quantitative measurements also measure how much revenue is generated per such unit of risk, the volatility of a trading unit's profitability, and the extent to which a trading unit trades with customers. Each of those characteristics appears to be useful in assessing whether a trading unit is engaged in permitted market making-related activity.

However, the Agencies recognize that no single quantitative measurement or combination of measurements can accurately identify prohibited proprietary trading without

¹⁸⁸ See proposed rule § __.7(a). The Agencies note that this \$1 billion trading asset and liability threshold is the same standard that is used in the Market Risk Capital Rules for determining which bank holding companies and insured depository institutions must calculate their risk-based capital requirements for trading positions under those rules. These banking entities maintain large and complex portfolios of trading assets and are therefore the most likely to be engaged in the types of trading activities that will require significant oversight of compliance with the restrictions on proprietary trading.

further analysis of the context, facts, and circumstances of the trading activity. In addition, certain quantitative measurements may be useful for assessing one type of trading activity, but not helpful in assessing another type of trading activity. As a result, the Agencies propose to use a variety of quantitative measurements to help identify transactions or activities that warrant more in-depth analysis or review.

To be effective, this approach requires identification of useful quantitative measurements as well as judgment regarding the type of measurement results that suggest a further review of the trading unit's activity is warranted. The Agencies intend to take a heuristic approach to implementation in this area that recognizes that quantitative measurements can only be usefully identified and employed after a process of substantial public comment, practical experience, and revision. In particular, the Agencies note that, although a variety of quantitative measurements have traditionally been used by market participants and others to manage the risks associated with trading activities, these quantitative tools have not been developed, nor have they previously been utilized, for the explicit purpose of identifying trading activity that warrants additional scrutiny in differentiating prohibited proprietary trading from permitted market making-related activities. Additional study and analysis will be required before quantitative measurements may be effectively designed and employed for that purpose.

Consistent with this heuristic approach, the proposed rule includes a large number of potential quantitative measurements on which public comment is sought, many of which overlap to some degree in terms of their informational value. Not all of these quantitative measurements may ultimately be adopted, depending on their relative strengths, weaknesses, costs, and benefits. The Agencies note that some of the proposed quantitative measurements may not be relevant to all types of trading activities or may provide only limited benefits, relative to cost, when applied to certain types of trading activities. In addition, certain quantitative measurements may be difficult or impracticable to calculate for a specific covered trading activity due to differences between asset classes, market structure, or other factors. The Agencies have therefore requested comment on a large number of issues related to the relevance, practicability, costs, and benefits of the quantitative measurements proposed. The Agencies also seek comment on whether the quantitative measurements described in the proposal may be appropriate to use in assessing compliance with section 13 of the BHC Act.

In addition to the proposed quantitative measurements, a banking entity may itself develop and implement other quantitative measurements in order to effectively monitor its covered trading activities for compliance with section 13 of the BHC Act and the proposed rule and to establish, maintain, and enforce an effective compliance program, as required by § __.20 of the proposed rule and Appendix C. The Agencies note that the proposed quantitative measurements in Appendix A are intended to assist banking entities and Agencies in monitoring compliance with the proprietary trading restrictions and, thus, are related to the compliance program requirements in § __.20 of the proposed rule and proposed Appendix C. Nevertheless, implementation of the proposed quantitative measurements under Appendix A would not necessarily provide all the data necessary for the banking entity to establish an effective compliance program, and a banking entity may need to develop and implement additional quantitative measurements. The Agencies recognize that appropriate and effective quantitative measurements may differ based on the profile of the banking entity's businesses in general and, more specifically, of the particular trading unit, including types of instruments traded, trading

activities and strategies, and history and experience (e.g., whether the trading desk is an established, successful market maker or a new entrant to a competitive market). In all cases, banking entities must ensure that they have robust measures in place to identify and monitor the risks taken in their trading activities, to ensure the activities are within risk tolerances established by the banking entity, and to monitor for compliance with the proprietary trading restrictions in the proposed rule.

To the extent that data regarding measurements, as set forth in the proposed rule, are collected, the Agencies propose to utilize the automatic two-year conformance period provided in section 13 of the BHC Act to carefully review that data, further study the design and utility of these measurements, and if necessary, propose changes to the reporting requirements as the Agencies believe are needed to ensure that these measurements are as effective as possible.¹⁸⁹ This heuristic, gradual approach to implementing reporting requirements for quantitative measurements would be intended to ensure that the requirements are formulated in a manner that maximizes their utility for identifying trading activity that warrants additional scrutiny in assessing compliance with the prohibition on proprietary trading, while limiting the risk that the use of quantitative measurements could inadvertently curtail permissible market making-related activities that provide an important service to market participants and the capital markets at large.

In addition, the Agencies request comment on the use of numerical thresholds for certain quantitative measurements that, if reported by a banking entity, would require the banking entity to review its trading activities for compliance and summarize that review to the relevant Agency. The Agencies have not proposed specific numerical thresholds in the proposal because substantial public comment and analysis would be beneficial prior to formulating and proposing specific numerical thresholds. Instead, the Agencies intend to carefully consider public comments that are provided on this issue and to separately determine whether it would be appropriate to propose, subsequent to finalizing the current proposal, such numerical thresholds.

The Agencies request comment on the proposed approach to implementing reporting requirements for proprietary trading. In particular, the Agencies request comment on the following questions:

Question [•]. Is the use of the proposed reporting requirements as part of the multi-faceted approach to implementing the prohibition on proprietary trading appropriate? Why or why not?

Question [•]. Is the proposed gradual approach to implementing reporting requirements effective? If not, what approach would be more effective? For example, should the Agencies defer reporting of quantitative measurements until banking entities have developed and refined their compliance programs through the supervision and examination process? What would be the costs and benefits of such an approach?

¹⁸⁹ Section 13(c)(2) of the BHC Act provides banking entities two years from the date that the proposed rule becomes effective (with the possibility of up to three, one-year extensions) to bring their activities, investments, and relationships into compliance with section 13, including the prohibition on proprietary trading. *See* 12 U.S.C. 1851(c)(2).

Question [•]. What role, if any, could or should the Office of Financial Research (“OFR”) play in receiving and analyzing banking entities’ reported quantitative measurements? Should reporting to the OFR be required instead of reporting to the relevant Agency, and would such reporting be consistent with the composition and purpose of OFR? In the alternative, should reporting to either (i) only the relevant Agency (or Agencies) or (ii) both the relevant Agency (or Agencies) and OFR be required? If so, why? What are the potential costs and benefits of reporting quantitative measurements to the OFR? Please explain.

Question [•]. Is there an alternative manner in which the Agencies should develop and propose the reporting requirements for quantitative measurements? If so, how should they do so?

Question [•]. Does the proposed approach provide sufficient time for the development and implementation of effective reporting requirements? If not, what alternative approach would be preferable?

Question [•]. Should a trading unit be permitted not to furnish a quantitative measurement otherwise required under Appendix A if it can demonstrate that the measurement is not, as applied to that unit, calculable or useful in achieving the purposes of the Appendix with respect to the trading unit’s covered trading activities? How might a banking entity make such a demonstration?

Question [•]. Is the manner in which the Agencies propose to utilize the conformance period for review of collected data and refinement of the reporting requirements effective? If not, what process would be more effective?

Question [•]. Is the proposed \$1 billion trading asset and liability threshold, which is also currently used in the Market Risk Capital Rules for purposes of identifying which banks and bank holdings companies must comply with those rules, an appropriate standard for triggering the reporting and recordkeeping requirements of the proposed rule? Why or why not? If not, what alternative standard would be a better benchmark for triggering the reporting and recordkeeping requirements?

Question [•]. What are the typical trading activities (e.g., market making-related activities) of a banking entity with less than \$1 billion in gross trading assets and liabilities? How complex are those trading activities?

Question [•]. Should the proposed \$1 billion trading and asset liability threshold used for triggering the reporting and recordkeeping requirements adjust each time the thresholds for complying with the Market Risk Capital Rules adjust, or otherwise be adjusted over time? If not, how and when should the numerical threshold be adjusted?

Question [•]. Should all banking entities be required to comply with the reporting and recordkeeping requirements set forth in Appendix A in order to better protect against prohibited proprietary trading, rather than only those banking entities that meet the proposed \$1 billion trading asset and liability threshold? Why or why not?

Question [•]. Should banking entities that fall under the proposed \$1 billion trading asset and liability threshold be required to comply with the reporting and recordkeeping provisions for a pilot period in order to help inform judgment regarding the levels of quantitative measurements at such entities and the appropriate frequency and scope of examination by the relevant Agency for such banking entities? Why or why not?

b. Proposed Appendix A - purpose and definitions.

Section I of proposed Appendix A describes the purpose of the appendix, which is to specify reporting requirements that are intended to assist banking entities that are engaged in significant trading activities and the Agencies in identifying trading activities that warrant further review or examination to verify compliance with the proprietary trading restrictions, including whether an otherwise-permitted activity under §§ __.4 through __.6(a) of the proposed rule is consistent with the requirement that such activity not result, directly or indirectly, in a material exposure by the banking entity to high-risk assets and high-risk trading strategies. In particular, section I provides that the purpose of the appendix is to assist the relevant Agency and banking entities in:

- Better understanding and evaluating the scope, type, and profile of the banking entity's covered trading activities;
- Monitoring the banking entity's covered trading activities;
- Identifying covered trading activities that warrant further review or examination by the banking entity to verify compliance with the proprietary trading restrictions;
- Evaluating whether the trading activities of trading units engaged in market making-related activities under § __.4(b) of the proposed rule are consistent with the requirements governing permitted market making-related activities;
- Evaluating whether the trading activities of trading units that are engaged in permitted trading activity under §§ __.4, __.5, or __.6(a) of the proposed rule (e.g., permitted underwriting, market making-related activity, risk-mitigating hedging, or trading in certain government obligations) are consistent with the requirement that such activity not result, directly or indirectly, in a material exposure by the banking entity to high-risk assets and high-risk trading strategies;
- Identifying the profile of particular trading activities of the banking entity, and the individual trading units of the banking entity, to help establish the appropriate frequency and scope of examination by the relevant Agency of such activities; and
- Assessing and addressing the risks associated with the banking entity's trading activities.

The types of trading and market making-related activities in which banking entities engage is often highly complex, and any quantitative measurement is capable of producing both "false negatives" and "false positives" that suggest that prohibited proprietary trading is

occurring when it is not, or vice versa. Recognizing this, section I of proposed Appendix A makes clear that the quantitative measurements that may be required to be reported would not be intended to serve as a dispositive tool for identifying permissible or impermissible activities.

Section II of proposed Appendix A defines relevant terms used in the appendix. These include certain definitions that clarify how and when certain calculations must be made, as well as a definition of “trading unit” that governs the level of organization at which a banking entity must calculate quantitative measurements. The proposed definition of “trading unit” covers multiple organizational levels of a banking entity, including:

- Each discrete unit engaged in the coordinated implementation of a revenue generation strategy that participates in the execution of any covered trading activity;¹⁹⁰
- Each organizational unit used to structure and control the aggregate risk-taking activities and employees of one or more trading units described above;
- All trading operations, collectively; and
- Any other unit of organization specified by the relevant Agency with respect to a particular banking entity.¹⁹¹

The definition of “trading unit” is intended to capture multiple layers of a banking entity’s organization structure, including individual trading desks, intermediate divisions that oversee a variety of trading desks, and all trading operations in the aggregate. As described below, under the proposal, the quantitative measurements specified in section IV of proposed Appendix A must be calculated and reported for each such “trading unit.” Accordingly, the definition of trading unit is purposefully broad and captures multiple levels of organization so as to ensure that quantitative measurements provide meaningful information, at both a granular and aggregate level, to help banking entities and the Agencies evaluate the quantitative profile of trading operations in a variety of contexts.

¹⁹⁰ As noted in Appendix A, the Agencies expect that this would generally be the smallest unit of organization used by the banking entity to structure and control its risk-taking activities and employees, and would include each unit generally understood to be a single “trading desk.” For example, if a banking entity has one set of employees engaged in market making-related activities in the equities of U.S. non-financial corporations, and another set of employees engaged in market making-related activities in the equities of U.S. financial corporations, the two sets of employees would appear to be part of a single trading unit if both sets of employees structure and control their trading activities together, making and executing highly coordinated decisions about required risk levels, inventory levels, sources of revenue growth and similar features. On the other hand, if the risk decisions and revenue strategies are considered and executed separately by the two sets of employees, with only loose coordination, they would appear to be two distinct trading units. In determining whether a set of employees constitute a single trading unit, important factors would likely include whether compensation is strongly linked to the group’s performance, whether risk levels and trading limits are managed and set jointly or separately, and whether trades are booked together or separately.

¹⁹¹ This latter prong of the definition has been included to ensure that the Agencies have the ability to require banking entities to report quantitative measurements in other ways to prevent a banking entity from organizing its trading operations so as to undermine the effectiveness of the reporting requirement.

The Agencies expect that the scope and nature of trading units to which the quantitative measurements are applied would have an important impact on the informational content and utility of the resulting measurements. Applying a quantitative measurement to a trading unit at a level that aggregates a variety of distinct trading activities may obscure or “smooth” differences between distinct lines of business, asset categories and risk management processes in a way that renders the measurement relatively uninformative, because it does not adequately reflect the specific characteristics of the trading activities being conducted. Similarly, applying a quantitative measurement to a trading unit at a highly granular level could, if it captured only a narrow portion of activity that is conducted as part of a broader business strategy, introduce meaningless “noise” into the measure or result in a measurement that is idiosyncratic in nature. This highly granular application could render the measurement relatively uninformative because it would not accurately reflect the entirety of the trading activities being conducted. In order to address the potential weaknesses of applying the quantitative measurements at an aggregate and a granular level, respectively, the proposal requires reporting at both levels. The informational inputs required to calculate any particular quantitative measurement at either level are the same. Consequently, it is expected that, depending on the nature of the systems of a particular institution, there may be little, if any, incremental burden associated with calculating and reporting quantitative measurements at multiple levels.

The Agencies request comment on the proposed reporting requirements in Appendix A. In particular, the Agencies request comment on the following questions:

Question [•]. Are the ways in which the proposed rule would make use of reported quantitative measurements effective? If not, what uses would be more effective? Should the proposed rule instead use quantitative measurements as a dispositive tool for identifying prohibited proprietary trading? If so, what types of quantitative measurements should be employed, what numerical amount would indicate impermissible proprietary trading activity, and why?

Question [•]. Are the proposed definitions of terms provided in Appendix A effective? If not, how should the definitions be amended?

Question [•]. Is the proposed definition of “trading unit” effective? Is it sufficiently clear? If not, what alternative definition would be more effective and/or clearer? Should the definition include more or less granular levels of activity? If so, what specific criteria should be used to determine the appropriate level of granularity?

Question [•]. If you are a banking entity, how would your trading activity be categorized, in terms of quantity and type, under the proposed definition of trading unit in Appendix A? For each trading unit type, what categories of quantitative measurements (e.g., risk-management measurements) or specific quantitative measurements (e.g., Stressed Value-at-Risk (“Stress VaR”)) are best suited to assist in distinguishing prohibited proprietary trading from permitted trading activity?

Question [•]. Is the proposed rule’s requirement that quantitative measurements be reported at multiple levels of organization, including for quantitative measurements historically reported on an aggregate basis (e.g., Value-at-Risk (“VaR”) or Stress VaR) appropriate? If not,

what alternative would be more effective? What burdens are associated with such a requirement? How might those burdens be reduced or limited? Please quantify your answers, to the extent feasible.

c. Proposed Appendix A - scope of required reporting.

Part III of proposed Appendix A defines the scope of the reporting requirements. The proposed rule adopts a tiered approach that requires banking entities with the most extensive trading activities to report the largest number of quantitative measurements, while banking entities with smaller trading activities have fewer or no reporting requirements. This tiered approach is intended to reflect the heightened compliance risks of banking entities with extensive trading activities and limit the regulatory burden imposed on banking entities with relatively small or no trading activities, which appear to pose significantly less compliance risk.

Banking entities with gross trading assets and liabilities of \$5 billion or more.

For any banking entity that has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, equals or exceeds \$5 billion, the proposal would require the banking entity to furnish quantitative measurements for all trading units of the banking entity engaged in trading activity subject to §§ __.4, __.5, or __.6(a) of the proposed rule (i.e., permitted underwriting and market making-related activity, risk-mitigated hedging, and trading in certain government obligations). The scope of data to be furnished depends on the activity in which the trading unit is engaged. First, for the trading units of such a banking entity that are engaged in market making-related activity pursuant to § __.4(b) of the proposed rule, proposed Appendix A requires that a banking entity furnish seventeen quantitative measurements.¹⁹² Second, all trading units of such a banking entity engaged in trading activity subject to §§ __.4(a), __.5, or __.6(a) of the proposed rule would be required to report five quantitative measurements designed to measure the general risk and profitability of the trading unit.¹⁹³ The Agencies expect that each of these general types of measurements will be useful in assessing the extent to which any permitted trading activity involves exposure to high-risk assets or high-risk trading strategies. These requirements would apply to all type of trading units engaged in underwriting and market making-related activity, risk-mitigated hedging, and trading in certain government obligations. These additional measurements are designed to help evaluate the extent to which the quantitative profile of a trading unit's activities is consistent with permissible market making-related activities.

Banking entities with gross trading assets and liabilities between \$1 billion and \$5 billion.

For any banking entity that has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured

¹⁹² See proposed rule Appendix A.III.A. These seventeen quantitative measurements are discussed further below.

¹⁹³ See proposed rule Appendix A.III.A. These five quantitative measurements are: (i) Comprehensive Profit and Loss; (ii) Comprehensive Profit and Loss Attribution; (iii) VaR and Stress VaR; (iv) Risk Factor Sensitivities; and (v) Risk and Position Limits. Each of these and other quantitative measurements discussed in proposed Appendix A are discussed in detail below.

as of the last day of each of the four prior calendar quarters, equals or exceeds \$1 billion but is less than \$5 billion, the proposal would require quantitative measurements to be furnished for trading units that are engaged in market making-related activity subject to § __.4(b) of the proposed rule. Trading units of such banking entities that are engaged in market making-related activities must report eight quantitative measurements that are designed to help evaluate the extent to which the quantitative profile of a trading unit's activities is consistent with permissible market making-related activities.¹⁹⁴ The proposal applies a smaller number of measurements to a smaller universe of trading units for this class of banking entities because they are likely to pose lesser compliance risk and fewer supervisory and examination challenges. A less burdensome reporting regime, coupled with other elements of the proposal (e.g., the compliance program requirement), is likely to be equally as effective in ensuring compliance with section 13 of the BHC Act and the proposed rule for banking entities with smaller trading operations.

Frequency of calculation and reporting.

Section III.B of proposed Appendix A specifies the frequency of required calculation and reporting of quantitative measurements. Under the proposed rule, each required quantitative measurement must be calculated for each trading day. Required quantitative measurements must be reported to the relevant Agency on a monthly basis, within 30 days of the end of the relevant calendar month, or on such other reporting schedule as the relevant Agency may require. Section III.C of proposed Appendix A requires a banking entity to create and retain records documenting the preparation and content of any quantitative measurement furnished by the banking entity, as well as such information as is necessary to permit the relevant Agency to verify the accuracy of such measurements, for a period of 5 years. This would include records for each trade and position.

Question [•]. Is the proposed tiered approach to identifying which banking entities and trading units must comply with the reporting requirements effective? If not, what alternative would be more effective? Does the proposal strike the appropriate balance between the potential benefits of the reporting requirements for monitoring and assuring compliance and the potential costs of those reporting requirements? If not, how could that balance be improved? Should the relevant gross trading assets and liabilities threshold for any category be increased or reduced? If so, why?

Question [•]. Should the \$1 billion and \$5 billion gross trading assets and liabilities thresholds used to identify the extent to which a banking entity is required to furnish quantitative measurements be increased or reduced? If so, why? Should the thresholds be indexed in some way to account for fluctuations in capital markets activity over time? If so, what would be an appropriate method of indexation?

Question [•]. Is the proposed \$5 billion trading asset and liability threshold an appropriate standard for triggering enhanced reporting requirements under the proposed rule?

¹⁹⁴ See proposed rule Appendix A.III.A. These eight quantitative measurements are (i) Comprehensive Profit and Loss; (ii) Comprehensive Profit and Loss Attribution; (iii) Portfolio Profit and Loss; (iv) Fee Income and Expense; (v) Spread Profit and Loss; (vi) VaR; (vii) Volatility of Comprehensive Profit and Loss and Volatility of Portfolio Profit and Loss; and (viii) Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio.

Why or why not? If not, what alternative standard would be a better benchmark for triggering enhanced reporting requirements?

Question [•]. Should the proposed \$5 billion trading and asset liability threshold used for triggering enhanced reporting requirements under the proposed rule be subject to adjustment over time? If so, how and when should the numerical threshold be adjusted?

Question [•]. Is there a different criterion other than gross trading assets and liabilities that would be more appropriate for identifying banking entities that must furnish quantitative measurements? If so, what is the alternative criterion, and why would it be more appropriate? Are worldwide gross trading assets and liabilities the appropriate criterion for foreign-based banking entities? If not, what alternative criterion would be more appropriate, and why?

Question [•]. Are the quantitative measurements specified for the various types of banking entities and trading units effective? If not, what alternative set of measurements would be more effective? For each type of trading unit, does the proposal strike the appropriate balance between the potential benefits of the reporting requirements for monitoring and assuring compliance and the potential costs of those reporting requirements? If not, how could that balance be improved?

Question [•]. Should banking entities with gross trading assets and liabilities between \$1 billion and \$5 billion also be required to calculate and report some of the quantitative measurements proposed for banking entities meeting the \$5 billion threshold for purposes of assessing whether the banking entity's underwriting, market making, risk-mitigating hedging, and trading in certain government obligations activities involve a material exposure to high-risk assets or high-risk trading strategies? If so, which quantitative measurements and why? If not, why not?

Question [•]. Is the proposed frequency of reporting effective? If not, what frequency would be more effective? Should the quantitative measurements be required to be reported quarterly, annually, or upon the request of the applicable Agency?

d. Proposed Appendix A - quantitative measurements.

Section IV of proposed Appendix A describes, in detail, the individual quantitative measurements that must be furnished. These measurements are grouped into the following five broad categories, each of which is described in more detail below:

- Risk-management measurements – VaR, Stress VaR, VaR Exceedance, Risk Factor Sensitivities, and Risk and Position Limits;
- Source-of-revenue measurements – Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income and Expense, Spread Profit and Loss, and Comprehensive Profit and Loss Attribution;
- Revenues-relative-to-risk measurements – Volatility of Comprehensive Profit and Loss, Volatility of Portfolio Profit and Loss, Comprehensive Profit and Loss to Volatility Ratio, Portfolio Profit and Loss to Volatility Ratio, Unprofitable Trading Days based on

Comprehensive Profit and Loss, Unprofitable Trading Days based on Portfolio Profit and Loss, Skewness of Portfolio Profit and Loss, and Kurtosis of Portfolio Profit and Loss;

- Customer-facing activity measurements – Inventory Turnover, Inventory Aging, and Customer-facing Trade Ratio; and
- Payment of fees, commissions, and spreads measurements – Pay-to-Receive Spread Ratio.

The Agencies have proposed these quantitative measurements because, taken together, these measurements appear useful for understanding the context in which trading activities occur and identifying activities that may warrant additional scrutiny to determine whether these activities involve prohibited proprietary trading because the trading activity either is inconsistent with permitted market making-related activities or presents a material exposure to high-risk assets or high-risk trading strategies. As described below, different quantitative measurements are proposed to identify different aspects and characteristics of trading activity for the purpose of helping to identify prohibited proprietary trading, and the Agencies expect that the quantitative measurements will be most useful for this purpose when implemented and reviewed collectively, rather than in isolation. The Agencies believe that, in the aggregate, many banking entities already collect and review many of these measurements as part of their risk management activities, and expect that many of the quantitative measurements proposed would be readily computed and monitored at the multiple levels of organization that are included in proposed Appendix A's definition of "trading unit," to which they would apply.

The first set of quantitative measurements relates to risk management, and includes VaR, Stress VaR, VaR Exceedance, Risk Factor Sensitivities, and Risk and Position Limits. These measurements are widely used by banking entities to measure and manage trading risks and activities. In the case of VaR, Stress VaR, VaR Exceedance, and Risk Factor Sensitivities, these measures provide internal, model-based assessments of overall risk, stated in terms of large but plausible losses that may occur or changes in revenue that would be expected to result from movements in underlying risk factors. In the case of Risk and Position Limits, the measure provides an explicit assessment of management's expectation of how much risk is required to perform permitted market-making and hedging activities. With the exception of Stress VaR, each of these measurements are routinely used to manage and control risk taking activities, and are also used by some banking entities for purposes of calculating regulatory capital and allocating capital internally. In the context of permitted market making-related activities, these risk management measures are useful in assessing whether the actual risk taken is consistent with the level of principal risk that a banking entity must retain in order to service the near-term demands of customers. Significant, abrupt or inconsistent changes to key risk management measures, such as VaR, that are inconsistent with prior experience, the experience of similarly situated trading units and management's stated expectations for such measures may indicate impermissible proprietary trading. In addition, indicators of unanticipated or unusual levels of risk taken, such as a significant number of VaR Exceedance or breaches of internal Risk and Position Limits, may suggest behavior that is inconsistent with appropriate levels of risk and may warrant further scrutiny.

The second set of quantitative measurements relates to the source of revenues, and includes Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income, Spread Profit and Loss, and Comprehensive Profit and Loss Attribution. These measurements are intended to capture the extent, scope, and type of profits and losses generated by trading activities and provide important context for understanding how revenue is generated by trading activities. Because permitted market making-related activities seek to generate profits by providing customers with intermediation and related services while maintaining, and to the extent practicable minimizing, the risks associated with any asset or risk inventory required to meet customer demands, these revenue measurements would appear to provide helpful information to banking entities and the Agencies regarding whether actual revenues are consistent with these expectations. The Agencies note that although banking entities already routinely calculate and analyze the extent and source of revenues derived from their trading activities, calculating the proposed source of revenue measurements according to the specifications described in proposed Appendix A may require banking entities to implement new processes to calculate and furnish the required data.

The third set of measurements relates to realized risks and revenue relative to realized risks, and includes Volatility of Profit and Loss, Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio, Unprofitable Trading Days based on Comprehensive Profit and Loss and Unprofitable Trading Days based on Portfolio Profit and Loss, and Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss. These measurements are intended to provide banking entities and the Agencies with ex post, data-based assessments of risk, as a supplement to internal, model-based assessments of risk, and give further context around the riskiness of underlying trading activities and the profitability of these activities relative to the risks taken. Some of these measurements, such as the skewness and kurtosis measurements, are proposed in order to capture asymmetric, “fat tail” risks that (i) are not well captured by simple volatility measures, (ii) may not be well captured by internal risk measurement metrics, such as VaR, and (iii) can be associated with proprietary trading strategies that seek to earn short-term profits by taking exposures to these types of risks. The Agencies expect that these realized-risk and revenue-relative-to-realized-risk measurements would provide information useful in assessing whether trading activities are producing revenues that are consistent, in terms of the degree of risk that is being assumed, with typical market making-related activities. Market making and related activities seek to generate profitability primarily by generating fees, commissions, spreads and other forms of customer revenue that are relatively, though not completely, insensitive to market fluctuations and generally result in a high level of revenue relative to risk over an appropriate time frame. In contrast, proprietary trading strategies seek to generate revenue primarily through favorable changes in asset valuations. The Agencies note that each of the proposed measurements relating to realized risks and revenues relative to realized risks are generally consistent with existing revenue, risk, and volatility data routinely collected by banking entities with large trading operations or are simple, standardized functions of such data.

The fourth set of quantitative measurements relates to customer-facing activity measurements, and includes Inventory Risk Turnover, Inventory Aging, and Customer-facing Trade Ratio. These measurements are intended to provide banking entities and Agencies with meaningful information regarding the extent to which trading activities are directed at servicing the demands of customers. Quantitative measurements such as Inventory Risk Turnover and

Inventory Aging assess the extent to which size and volume of trading activity is aimed at servicing customer needs, while the Customer-facing Trade Ratio provides directionally useful information regarding the extent to which trading transactions are conducted with customers. The Agencies expect that these measurements will be useful in assessing whether permitted market making-related activities are focused on servicing customer demands. Although the Agencies understand that banking entities typically measure inventory aging and turnover in the context of cash instruments (e.g., equity and debt securities), they note that applying these measurements, as well as the Customer-facing Trade Ratio generally, would require banking entities to implement new processes to calculate and furnish the related data.

The fifth set of quantitative measurements relates to the payment of fees, commissions, and spreads, and includes the Pay-to-Receive Spread Ratio. This measurement is intended to measure the extent to which trading activities generate revenues for providing intermediation services, rather than generate expenses paid to other intermediaries for such services. Because market making-related activities ultimately focus on servicing customer demands, they typically generate substantially more fees, spreads and other sources of customer revenue than must be paid to other intermediaries to support customer transactions. Proprietary trading activities, however, that generate almost no customer facing revenue will typically pay a significant amount of fees, spreads and commissions in the execution of trading strategies that are expected to benefit from short term price movements. Accordingly, the Agencies expect that the proposed Pay-to-Receive Spread Ratio measurement will be useful in assessing whether permitted market making-related activities are primarily generating, rather than paying, fees, spreads and other transactional revenues or expenses. A level of fees, commissions, and spreads paid that is inconsistent with prior experience, the experience of similarly situated trading units and management's stated expectations for such measures could indicate impermissible proprietary trading.

For each individual quantitative measurement, proposed Appendix A describes the measurement, provides general guidance regarding how the measurement should be calculated (where needed) and specifies the period over which each calculation should be made. The proposed quantitative measurements attempt to incorporate, wherever possible, measurements already used by banking entities to manage risks associated with their trading activities. Of the measurements proposed, the Agencies expect that a large majority of measurements proposed are either (i) already routinely calculated by banking entities or (ii) based solely on underlying data that are already routinely calculated by banking entities. However, calculating these measurements according to the specifications described in proposed Appendix A and at the various levels of organization mandated may require banking entities to implement new processes to calculate and furnish the required data.

The extent of the burden associated with calculating and reporting quantitative measurements will likely vary depending on the particular measurements and differences in the sophistication of management information systems at different banking entities. As noted, the proposal tailors these data collections to the size and type of activity conducted by each banking entity in an effort to minimize the burden in particular on firms that engage in few or no trading activities subject to the proposed rule.

The Agencies have also attempted to provide, to the extent possible, a standardized description and general method of calculating each quantitative measurement that, while taking into account the potential variation among trading practices and asset classes, would facilitate reporting of sufficiently uniform information across different banking entities so as to permit horizontal reviews and comparisons of the quantitative profile of trading units across firms.

The Agencies request comment on the proposed quantitative measurements. In particular, the Agencies request comment on the following questions:

Question [•]. Are the proposed quantitative measurements appropriate in general? If not, what alternative(s) would be more appropriate, and why? Should certain quantitative measurements be eliminated, and if so, why? Should additional quantitative measurements be added? If so, which measurements and why? How would those additional measurements be described and calculated?

Question [•]. How many of the proposed quantitative measurements do banking entities currently utilize? What are the current benefits and costs associated with calculating such quantitative measurements? Would the reporting and recordkeeping requirements proposed in Appendix A for such quantitative measurements impose any significant, additional benefits or costs?

Question [•]. Which of the proposed quantitative measurements do banking entities currently not utilize? What are the potential benefits and costs to calculating these quantitative measurements and complying with the proposed reporting and recordkeeping requirements? Please quantify your answers, to the extent feasible.

Question [•]. Is the scope and frequency of required reporting appropriate? If not, what alternatives would be more appropriate? What burdens would be associated with reporting quantitative measurements on that basis, and how could those burdens be reduced or eliminated in a manner consistent with the purpose and language of the statute? Please quantify your answers, to the extent feasible.

Question [•]. For each of the categories of quantitative measurements (e.g., quantitative measurements relating to risk management), what factors should be considered in order to further refine the proposed category of quantitative measurements to better distinguish prohibited proprietary trading from permitted trading activity? For example, should the timing of a calculation be considered significant in certain contexts (e.g., should specific quantitative measurements be calculated during the middle of a trading day instead of the end of the day)? Please quantify your answers, to the extent feasible.

Question [•]. In light of the size, scope, complexity, and risk of covered trading activities, do commenters anticipate the need to hire new staff with particular expertise in order to calculate the required quantitative measurements (e.g., collect data and make computations)? Do commenters anticipate the need to develop additional infrastructure to obtain and retain data necessary to compute the proposed quantitative measurements? Please explain and quantify your answers, to the extent feasible.

Question [•]. For each individual quantitative measurement that is proposed:

- Is the use of the quantitative measurement to help distinguish between permitted and prohibited trading activities effective? If not, what alternative would be more effective? Does the quantitative measurement provide any additional information of value relative to other quantitative measurements proposed?
- Is the use of the quantitative measurement to help determine whether an otherwise-permitted trading activity is consistent with the requirement that such activity must not result, directly or indirectly, in a material exposure by the banking entity to high-risk assets and high-risk trading strategies effective? If not, what alternative would be more effective?
- What factors should be considered in order to further refine the proposed quantitative measurement to better distinguish prohibited proprietary trading from permitted trading activity? For example, should the timing of a calculation be considered significant in certain contexts (e.g., should specific quantitative measurements be calculated during the middle of a trading day instead of at the end of the day)?
- If the quantitative measurement is proposed to be applied to a trading unit that is engaged in activity pursuant to §§ __.4(a), __.5, or __.6(a) of the proposed rule, is the quantitative measurement calculable in relation to such activity? Is the quantitative measurement useful for determining whether underwriting, risk-mitigating hedging, or trading in certain government obligations is resulting, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies?
- Is the description of the quantitative measurement sufficiently clear? What alternative would be more appropriate or clearer? Is the description of the quantitative measurement appropriate, or is it overly broad or narrow? If it is overly broad, what additional clarification is needed? Should the Agencies provide this additional clarification in the appendix's description of the quantitative measurement? If the description is overly narrow, how should it be modified to appropriately describe the quantitative measurement, and why?
- Is the general calculation guidance effective and sufficiently clear? If not, what alternative would be more effective or clearer? Is more or less specific calculation guidance necessary? If so, what level of specificity is needed to calculate the quantitative measurement? What are the different calculation options and methodologies that could be used to reach the desired level of specificity? What are the costs and benefits of these different options? If the proposed calculation guidance is not sufficiently specific, how should the calculation guidance be modified to reach the appropriate level of specificity? For example, rather than provide this level of specificity in proposed Appendix A, should the Agencies instead make each banking entity responsible for determining the best method of calculating the quantitative measurement at this level of specificity, based on the banking entity's business and profile, which would then be subject to supervision, review, or examination by the relevant Agency? If the proposed calculation guidance is overly specific, why is it too specific and how should the guidance be modified to reach the appropriate level of specificity?
- Is the general calculation guidance for the measurement consistent with how banking entities currently calculate the quantitative measurement, if they do so? If not, how does

the proposed guidance differ from methodology currently used by banking entities? What is the purpose of the current calculation methodology used by banking entities?

- What operational or logistical challenges might be associated with performing the calculation of the quantitative measurement and obtaining any necessary informational inputs?
- Is the quantitative measurement not calculable for any specific type of trading unit? If so, what type of trading unit, and why is the quantitative measurement not calculable for that type of trading unit? Is there an alternative quantitative measurement that would reflect the same trading activity but not pose the same calculation difficulty? Are there particular challenges to documenting that a specific quantitative measurement is not calculable?
- Is the quantitative measurement substantially likely to frequently produce false negatives or false positives that suggest that prohibited proprietary trading is occurring when it is not, or vice versa? If so, why? If so, what alternative quantitative measurement would better help identify prohibited proprietary trading?
- Should the quantitative measurement better account for distinctions among trading activities, trading strategies, and asset classes? If so, how? For example, should the quantitative measurements better account for distinctions between trading activities in cash and derivatives markets? If so, how? Are there any other distinctions for which the quantitative measurements may need to account? If so, what distinctions, and why?
- Does the quantitative measurement provide useful information as applied to all types of trading activities, or only a certain subset of trading activities? If it only provides useful information for a subset of trading activities, how should this issue be addressed? How beneficial is the information that the quantitative measurement provides for this subset of trading activities? Do any of the other quantitative measurements provide the same level of beneficial information for this subset of trading activities? Should the quantitative measurement be required to be reported for all trading activities, only a relevant subset of trading activities, or not at all?
- Does the quantitative measurement provide useful information as applied to all asset classes, or only a certain subset of asset classes? If it only provides useful information for a subset of asset classes, how should this issue be addressed? How beneficial is the information the quantitative measurement provides for this subset of asset classes? Do any of the other quantitative measurements provide the same level of beneficial information for this subset of asset classes? Should the quantitative measurement be required to be reported for all asset classes, only a relevant subset of asset classes, or not at all?
- Is the calculation period effective and sufficiently clear? If not, what alternative would be more effective or clearer?
- How burdensome and costly would it be to calculate the measurement at the specified calculation frequency and calculation period? Are there any difficulties or costs associated with calculating the measurement for particular trading units? How significant are those potential costs relative to the potential benefits of the measurement in monitoring for

impermissible proprietary trading? Are there potential modifications that could be made to the measurement that would reduce the burden or cost? If so, what are those modifications? Please quantify your answers, to the extent feasible.

Proposed Appendix B - commentary regarding identification of permitted market making-related activities.

Proposed Appendix B provides commentary that is intended to assist a banking entity in distinguishing permitted market making-related activities from trading activities that, even if conducted in the context of a banking entity's market making operations, would constitute prohibited proprietary trading. As noted in Part I of proposed Appendix B, the commentary applies to all banking entities that are engaged in market making-related activities in reliance on § __.4(b) of the proposed rule. Part II of proposed Appendix B clarifies that all defined terms used in Appendix B have the meaning given those terms in §§ __.2 and __.3 of the proposed rule and Appendix A.

The commentary regarding identification of permitted market making-related activities, which is contained in Part III of proposed Appendix B, includes three principal components. The first component provides an overview of market making-related activities and describes, in detail, typical practices in which market makers engage and typical characteristics of market making-related activities, articulating the general framework within which the Agencies view market making-related activities.¹⁹⁵ For example, the commentary provides that market making-related activities, in the context of a banking entity acting as principal, generally involve either (i) in the case of market making in a security that is executed on an organized trading facility or exchange, passively providing liquidity by submitting resting orders that interact with the orders of others on an organized trading facility or exchange and acting as a registered market maker, where such exchange or organized trading facility provides the ability to register as a market maker, or (ii) in other cases, providing an intermediation service to its customers by assuming the role of a counterparty that stands ready to buy or sell a position that the customer wishes to sell or buy. The second component of the commentary provides an overview of prohibited proprietary trading activities, which describes the general framework within which the Agencies view prohibited proprietary trading and contrasts that activity to the practices and characteristics of market making-related activities.¹⁹⁶ The third component describes certain challenges that arise in distinguishing permitted market making-related activities and prohibited proprietary trading, particularly in cases in which both of these activities occur within the context of a market making operation,¹⁹⁷ and proposes guidance that the Agencies would apply in distinguishing permitted market making-related activities from prohibited proprietary trading. This guidance includes six factors that would cause a banking entity to be considered, absent

¹⁹⁵ See proposed rule Appendix B, § III.A. The practices and characteristics that are described generally reinforce and augment the specific requirements that a banking entity must meet in order to rely on the market-making exemption under § __.4(b) of the proposed rule.

¹⁹⁶ See proposed rule Appendix B, § III.B.

¹⁹⁷ See proposed rule Appendix B, § III.C. Proposed Appendix B notes, for example, that it may be difficult to distinguish (i) inventory positions that appropriately support market making-related activities from (ii) positions taken for proprietary purposes. See *id.*

explanatory circumstances, to be engaged in prohibited proprietary trading, and not permitted market making-related activity. The six factors are:

- Trading activity in which a trading unit retains risk in excess of the size and type required to provide intermediation services to customers;¹⁹⁸
- Trading activity in which a trading unit primarily generates revenues from price movements of retained principal positions and risks, rather than customer revenues;
- Trading activity in which a trading unit: (i) generates only very small or very large amounts of revenue per unit of risk taken; (ii) does not demonstrate consistent profitability; or (iii) demonstrates high earnings volatility;
- Trading activity in which a trading unit either (i) does not transact through a trading system that interacts with orders of others or primarily with customers of the banking entity's market making desk to provide liquidity services, or (ii) holds principal positions in excess of reasonably expected near term customer demands;
- Trading activity in which a trading unit routinely pays rather than earns fees, commissions, or spreads; and
- The use of compensation incentives for employees of a particular trading activity that primarily reward proprietary risk-taking.¹⁹⁹

The proposed commentary makes clear that the enumerated factors are subject to certain facts and circumstances that may explain why a trading activity may meet one or more factors but does not involve prohibited proprietary trading, and provides a range of examples of such explanatory facts and circumstances.²⁰⁰ The Agencies emphasize that these examples are not meant to be exhaustive, as a variety of other circumstances may exist to explain why a particular

¹⁹⁸ For simplicity and ease of reading, the Agencies have used the term "customer" throughout the discussion of market making-related activity. However, as discussed in proposed Appendix B, a market maker's "customers" generally vary depending on the asset class and market in which the market maker is providing intermediation services. In the context of market making in a security that is executed on an organized trading facility or an exchange, a "customer" is any person on behalf of whom a buy or sell order has been submitted by a broker-dealer or any other market participant. In the context of market making in a covered financial position in an over-the-counter market, a "customer" generally would be a market participant that makes use of the market maker's intermediation services, either by requesting such services or entering into a continuing relationship with the market maker with respect to such services. In certain cases, depending on the conventions of the relevant market (e.g., the over-the-counter derivatives market), such a "customer" may consider itself or refer to itself more generally as a "counterparty."

¹⁹⁹ See proposed rule Appendix B, § III.C.1 – 6. The Agencies note that each of these six criteria is directly related to the overview of market making-related activities provided in section III.A. of proposed Appendix B.

²⁰⁰ The proposed commentary does not contemplate explanatory facts and circumstances for the compensation incentives factor, given that the choice of compensation incentives provided to trading personnel is under the full control of the banking entity.

trading activity, even if meeting one of the factors, may nonetheless be a permitted market making-related activity.²⁰¹

In addition, for each of these six factors, the proposed rule provides general guidance as to (i) the types of facts and circumstances on which the relevant Agency may base any determination that a banking entity's trading activity met the relevant factor and (ii) which quantitative measurements, if furnished by a banking entity pursuant to Appendix A, the relevant Agency would use to help assess the extent to which a banking entity's activities met the relevant factor.

The Agencies request comment on the proposed commentary regarding identification of permitted market making-related activities. In particular, the Agencies request comment on the following questions:

Question [•]. Is the overview of permitted market making-related activities and prohibited proprietary trading proposed in Appendix B accurate? If not, what alternative overview would be more accurate? Does the overview appropriately account for differences in market making-related activities across different asset classes? If not, which type of market making-related activity does the overview not sufficiently describe or account for?

Question [•]. Is the requirement that a market maker engaged in market making that is executed on an exchange or an organized trading facility must be a registered market maker, provided the relevant exchange or organized trading facility provides the ability to register, appropriate, or is it over- or under-inclusive? Please Discuss and provide detailed examples of any such markets where registering as a market maker is not feasible or should not be required, and unregistered market makers provide similar services or perform similar functions.

Question [•]. With respect to market making that is executed on an exchange or an organized trading facility, what potential impact or unintended consequences might result from limiting the market making exemption to registered market makers when the relevant exchange or organized trading facility registers market makers? Would such a requirement result in any potential decrease in the passive provision of liquidity by the submission of resting orders? Do you anticipate that any such decrease would be exacerbated in times of market stress? If yes, please describe the impact on liquidity and the marketplace in general. Please discuss whether and how any potential decrease in liquidity could be mitigated. In addition, would such a requirement result in additional costs that would be borne by market participants purchasing and selling on an exchange or organized trading facility? Please identify and discuss any other additional costs. Please discuss whether and how any such consequences can be mitigated.

Question [•]. In addition to benefits discussed in the Supplementary Information, are there other benefits that would be achieved by requiring that a market maker be registered with respect to market making on an exchange or an organized trading facility? Is there a way to amplify these benefits? Could these benefits be realized through alternative means? If so, how?

²⁰¹ The Agencies also note that, although a particular trading activity may not meet the requirements applicable to permitted market making-related activities, it may still be exempt under another available exemption.

Question [•]. In addition to registered market makers on exchanges or organized trading facilities, what other classes of liquidity providers exist? Are their obligations and activities similar to, or different than those of registered market makers? If so, how? Are the compensated in a different manner?

Question [•]. How much liquidity is provided by registered market makers versus other liquidity providers by asset class (e.g., equities, etc.) with respect to trading on an exchange or an organized trading facility? We encourage commenters to provide data in support of comments.

Question [•]. Is there any specific element of market making-related activity that the overview does not take into account in its description of market making? If so, how should the overview account for this element? Are there any descriptions of market making-related activity in the overview that should not be considered to be market making-related activity? If so, why? Is there any specific element of prohibited proprietary trading activity that the overview does not take into account in its description of prohibited proprietary trading? If so, how should the overview account for this element? Are there any descriptions of prohibited proprietary trading activity in the overview that should not be considered to be prohibited proprietary trading? If so, why?

Question [•]. Are each of the six factors specified for helping to distinguish permitted market making-related activity from prohibited proprietary trading appropriate? If not, how should they be changed, and why? Should any factors be eliminated or added? If so, which ones and why? Could any of the proposed factors occur as a result of the banking entity engaging in one of the other permitted activities (e.g., underwriting, trading on behalf of customers)? If so, would the facts and circumstances that the Agencies propose to consider be sufficient to determine and verify that the banking entity is not engaged in prohibited proprietary trading? If not, how should this issue be addressed?

Question [•]. Are the facts and circumstances that would be used to determine whether a banking entity's activities satisfy a certain factor appropriate? If not, how should they be changed, and why? Should any be eliminated or added? If so, which ones, and why?

Question [•]. Are the identified quantitative measurements that the Agencies would use to help assess a particular factor appropriate? If not, how should they be changed, and why? Should any be eliminated or added? If so, which ones, and why?

f. Incorporation of numerical thresholds in the commentary regarding identification of permitted market making-related activities.

As noted above, the Agencies are currently requesting comment on whether to incorporate, as part of the proposed rule, numerical thresholds for certain quantitative measurements, and if so, how to do so. For example, the proposed rule could include one or more numerical thresholds that, if met by a banking entity, would require the banking entity to review its trading activities for compliance and summarize that review to the relevant Agency.

The primary purpose of using some form of threshold would be to provide banking entities with a clear standard regarding trading activity that presented a quantitative profile

sufficiently questionable to warrant further review and explanation to the relevant Agency. Such clarity would appear to provide significant benefits both to banking entities in conducting their trading activities in conformance with the proposed rule and to Agencies in monitoring trading activities and obtaining additional, more detailed information in circumstances warranting closer scrutiny. In addition to the benefits of transparency, thresholds would also encourage consistent review by banking entities and the Agencies of transactions, both within a banking entity and across all banking entities. The purpose of such thresholds would not be to serve as bounds of permitted conduct or as a comprehensive, dispositive tool for determining whether prohibited proprietary trading has occurred.

Numerical thresholds have not been included in the proposed rule because the Agencies believe that public comment and further review is warranted before numerical thresholds and specific numerical amounts may be proposed. Instead, the Agencies request comment on whether such thresholds would be desirable and, if so, what particular form such thresholds should take and what specific numerical thresholds would be appropriate. To facilitate the comment process, this request for comment includes a number of illustrative examples of numerical thresholds on which specific comment is sought.

In particular, the Agencies request comment on the following questions:

Question [•]. What are the potential benefits and costs of incorporating into the proposed rule one or more numerical thresholds for certain quantitative measurements that, if reported by a banking entity, would require the banking entity to review its trading activities for compliance and summarize that review to the relevant Agency? Would such thresholds provide useful clarity to banking entities and/or market participants regarding the types of trading activities that merit additional scrutiny? Should numerical thresholds be used for any purposes other than highlighting trading activities that should be reviewed, the results of which would be reported to the relevant Agency? If so, for what purpose, and how and why?

Question [•]. For which of the relevant quantitative measurements might it be appropriate and effective to include a numerical threshold that would trigger banking entity review and explanation? How should a numerical threshold be formulated, and why? Should a numerical threshold for a single quantitative measurement be applied individually, or should the threshold instead be triggered by exceeding some combination of numerical thresholds for different measurements? For any particular threshold, what numerical amount should be used, and why? How would such numerical amount be consistent with a level at which further review and explanation is warranted? Should the amount vary by asset class or other characteristic? If so, how?

Question [•]. For each of the following illustrative examples of potential thresholds, is the threshold formulated effectively? If not, what alternative formulation would be more effective? Should the threshold formulation vary by asset class or other characteristic? If so, how and why? If the threshold was utilized, what actual numerical amount should be specified, and why? How would such numerical amount be consistent with a level at which further review and explanation is warranted? Should the numerical amount vary by asset class or other characteristic? If so, how and why?

- “If a trading unit reports an increase in VaR, Stress VaR, or Risk Factor Sensitivities greater than [__] over a period of [__] months, or such other threshold as [Agency] may require, the banking entity must (i) promptly review and investigate the trading unit’s activities to verify whether the trading unit is operating in compliance with the proprietary trading restrictions and (ii) report to [Agency] a summary of such review, including any explanatory circumstances.”

- “If a trading unit reports an average Comprehensive Profit and Loss that is less than [__] times greater than the Portfolio Profit and Loss, exclusive of Spread Profit and Loss, for [__] consecutive months, or such other threshold as [Agency] may require, the banking entity must (i) promptly review and investigate the trading unit’s activities to verify whether the trading unit is operating in compliance with the proprietary trading restrictions and (ii) report to [Agency] a summary of such review, including any explanatory circumstances.”

- “If a trading unit reports a Comprehensive Profit and Loss to Volatility Ratio that is less than [__] times greater than that trading desk’s Portfolio Profit and Loss to Volatility Ratio over a period of [__] months, or such other threshold as [Agency] may require, the banking entity must (i) promptly review and investigate the trading unit’s activities to verify whether the trading unit is operating in compliance with the proprietary trading restrictions and (ii) report to [Agency] a summary of such review, including any explanatory circumstances.”

- “If a trading unit reports a number of Unprofitable Trading Days Based on Portfolio Profit and Loss that is less than [__] greater than the number of Unprofitable Trading Days Based on Comprehensive Profit and Loss for [__] consecutive months, or such other threshold as [Agency] may require, the banking entity must (i) promptly review and investigate the trading unit’s activities to verify whether the trading unit is operating in compliance with the proprietary trading restrictions and (ii) report to [Agency] a summary of such review, including any explanatory circumstances.”

- “If a trading unit reports a Pay-to-Receive Spread Ratio that is less than [__] over a period of [__] months, or such other threshold as [Agency] may require, the banking entity must (i) promptly review and investigate the trading unit’s activities to verify whether the trading unit is operating in compliance with the proprietary trading restrictions and (ii) report to [Agency] a summary of such review, including any explanatory circumstances.”

6. Section __.8: Limitations on permitted trading activities.

Section __.8 of the proposed rule implements section 13(d)(2) of the BHC Act, which places certain limitations on the permitted trading activities (e.g., permitted market making-related activities, risk-mitigating hedging, etc.) in which a banking entity may engage.²⁰² Consistent with the statute, § __.8(a) of the proposed rule provides that no transaction, class of transactions, or activity is permissible under §§ __.4 through __.6 of the proposed rule if the transaction, class of transactions, or activity would:

²⁰² See 12 U.S.C. 1851(d)(2).

- Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;
- Result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or
- Pose a threat to the safety and soundness of the banking entity or U.S. financial stability.

The proposed rule further defines “material conflict of interest,” “high-risk asset,” and “high-risk trading strategy” for these purposes.

a. Definition of “material conflict of interest”.

Section __.8(b) of the proposed rule defines the scope of material conflicts of interest which, if arising in connection with a permitted trading activity, are prohibited under the proposal.²⁰³ Conflicts of interest may arise in a variety of circumstances related to permitted trading activities. For example, a banking entity may acquire substantial amounts of nonpublic information about the financial condition of a particular company or issuer through its lending, underwriting, investment advisory or other activities which, if improperly transmitted to and used in trading operations, would permit the banking entity to use such information to its customers’, clients’ or counterparties’ disadvantage. Similarly, a banking entity may conduct a transaction that places the banking entity’s own interests ahead of its obligations to its customers, clients or counterparties, or it may seek to gain by treating one customer involved in a transaction more favorably than another customer involved in that transaction. Concerns regarding conflicts of interest are likely to be elevated when a transaction is complex, highly structured or opaque, involves illiquid or hard-to-value instruments or assets, requires the coordination of multiple internal groups (such as multiple trading desks or affiliated entities), or involves a significant asymmetry of information or transactional data among participants.²⁰⁴ In all cases, the existence of a material conflict of interest depends on the specific facts and circumstances.

To address these types of material conflicts of interest, § __.8(b) of the proposed rule specifies that a material conflict of interest between a banking entity and its clients, customers, or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity’s interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity, unless the banking entity has appropriately addressed and mitigated the conflict of interest, where possible, and subject to specific requirements provided in the proposal, through either (i) timely and effective disclosure, or (ii) informational barriers.²⁰⁵ Unless the

²⁰³ Section __.17(b) of the proposed rule defines the scope of material conflicts of interest which, if arising in connection with permitted covered fund activities, are prohibited.

²⁰⁴ See, e.g., U.S. Senate Permanent Subcommittee on Investigations, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE (Apr. 13, 2011), available at http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf.

²⁰⁵ See proposed rule § __.8(b)(1).

conflict of interest is addressed and mitigated in one of the two ways specified in the proposal, the related transaction, class of transactions or activity would be prohibited under the proposed rule, notwithstanding the fact that it may be otherwise permitted under §§ __.4 through __.6 of the proposed rule.²⁰⁶

However, for purposes of the proposed rule, the mere fact that the buyer and seller are on opposite sides of a transaction and have differing economic interests would not be deemed a “material” conflict of interest with respect to transactions related to bona fide underwriting, market making, risk-mitigating hedging or other permitted activities, assuming the activities are conducted in a manner that is consistent with the proposed rule and securities and banking laws and regulations.

Section __.8(b)(1) of the proposed rule describes the two requirements that must be met in cases where a banking entity addresses and mitigates a material conflict of interest through timely and effective disclosure. First, § __.8(b)(1)(i) of the proposed rule requires that the banking entity, prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, for which a conflict may arise, make clear, timely, and effective disclosure of the conflict or potential conflict of interest, together with any other necessary information.²⁰⁷ This would also require such disclosure to be provided in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest.²⁰⁸ Disclosure that is only general or generic, rather than specific to the individual, class, or type of transaction or activity, or that omits details or other information that would be necessary to a reasonable client’s, customer’s, or counterparty’s understanding of the conflict of interest, would not meet this standard. Second, § __.8(b)(1)(ii) of the proposed rule requires that the disclosure be made explicitly and effectively, and in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty that was created or would be created by the conflict or potential conflict.²⁰⁹

The Agencies note that, in order to provide the requisite opportunity for the client, customer or counterparty to negate or substantially mitigate the disadvantage created by the conflict, the disclosure would need to be provided sufficiently close in time to the client’s, customer’s, or counterparty’s decision to engage in the transaction or activity to give the client, customer, or counterparty an opportunity to meaningfully evaluate and, if necessary, take steps that would negate or substantially mitigate the conflict. Disclosure provided far in advance of the individual, class, or type of transaction, such that the client, customer, or counterparty is unlikely to take that disclosure into account when evaluating a transaction, would not suffice. Conversely, disclosure provided without a sufficient period of time for the client, customer, or counterparty to evaluate and act on the information it receives, or disclosure provided after the

²⁰⁶ The Agencies note that a banking entity subject to Appendix C must implement a compliance program that includes, among other things, policies and procedures that explain how the banking entity monitors and prohibits conflicts of interest with clients, customers, and counterparties.

²⁰⁷ See proposed rule § __.8(b)(1)(A).

²⁰⁸ See id.

²⁰⁹ See proposed rule § __.8(b)(1)(B).

fact, would also not suffice under the proposal. The Agencies note that the proposed definition would not prevent or require disclosure with respect to transactions or activities that align the interests of the banking entity with its clients, customers, or counterparties or that otherwise do not involve “material” conflicts of interest as discussed above.

The proposed disclosure standard reflects the fact that some types of conflicts may be appropriately resolved through the disclosure of clear and meaningful information to the client, customer, or counterparty that provides such party with an informed opportunity to consider and negate or substantially mitigate the conflict. However, in the case of a conflict in which a client, customer, or counterparty does not have sufficient information and opportunity to negate or mitigate the materially adverse effect on the client, customer, or counterparty created by the conflict, the existence of that conflict of interest would prevent the banking entity from availing itself of any exemption (e.g., the underwriting or market-making exemptions) with respect to the relevant transaction, class of transactions, or activity. The Agencies note that the proposed disclosure provisions are provided solely for purposes of the proposed rule’s definition of material conflict of interest, and do not affect a banking entity’s obligation to comply with additional or different disclosure or other requirements with respect to a conflict under applicable securities, banking, or other laws (e.g., section 27B of the Securities Act, which governs conflicts of interest relating to certain securitizations; section 206 of the Investment Advisers Act of 1940, which governs conflicts of interest between investment advisers and their clients; or 12 CFR 9.12, which applies to conflicts of interest in the context of a national bank’s fiduciary activities).

Section __.8(b)(2) of the proposed rule describes the requirements that must be met in cases where a banking entity uses information barriers that are reasonably designed to prevent a material conflict of interest from having a materially adverse effect on a client, customer or counterparty. Information barriers can be used to restrict the dissemination of information within a complex organization and to prevent material conflicts by limiting knowledge and coordination of specific business activities among units of the entity. Examples of information barriers include, but are not limited to, restrictions on information sharing, limits on types of trading, and greater separation between various functions of the firm. Information barriers may also require that banking entity units or affiliates have no common officers or employees. Such information barriers have been recognized in Federal securities laws and rules as a means to address or mitigate potential conflicts of interest or other inappropriate activities.²¹⁰

In order to address and mitigate a conflict of interest through the use of the information barriers pursuant to § __.8(b)(2) of the proposed rule, a banking entity would be required to establish, maintain, and enforce information barriers that are memorialized in written policies and procedures, including physical separation of personnel, functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity’s business, to prevent the conflict of interest from involving or resulting in a materially adverse

²¹⁰ For example, information barriers have been used in complying with the requirement in section 15(g) of the Exchange Act that registered brokers and dealers establish, maintain and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker’s or dealer’s business, to prevent the misuse of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer.

effect on a client, customer or counterparty.²¹¹ Importantly, the proposed rule also provides that, notwithstanding a banking entity's establishment of such information barriers, if the banking entity knows or should reasonably know that a material conflict of interest arising out of a specific transaction, class or type of transactions, or activity may involve or result in a materially adverse effect on a client, customer, or counterparty, the banking entity may not rely on those information barriers to address and mitigate any conflict of interest. In such cases, the transaction or activity would be prohibited, unless the banking entity otherwise complies with the requirements of § __.8(b)(1).²¹² This aspect of the proposal is intended to make clear that, in specific cases in which a banking entity has established an information barrier but knows or should reasonably know that it has failed or will fail to prevent a conflict of interest arising from a specific transactions or activity that disadvantages a client, customer, or counterparty, the information barrier is insufficient to address that conflict and the transaction would be prohibited, unless the banking entity is otherwise able to address and mitigate the conflict through timely and effective disclosure under the proposal.²¹³

The Agencies note that the proposed definition of material conflict of interest does not address instances in which a banking entity has made a material misrepresentation to its client, customer, or counterparty in connection with a transaction, class of transactions, or activity, as such transactions or activity appears to involve fraud rather than a conflict of interest. However, the Agencies note that such misrepresentations are generally illegal under a variety of Federal and State regulatory schemes (e.g., the Federal securities laws). In addition, the Agencies note that any activity involving a material misrepresentation to, or other fraudulent conduct with respect to, a client, customer, or counterparty would not be permitted under the proposed rule in the first instance. For example, a trading activity involving a material misrepresentation to a client, customer, or counterparty would fail, on its face, to satisfy the proposed terms of the underwriting or market-making exemptions, as *bona fide* underwriting and market making-related activity would in no case encompass activity involving such a misrepresentation.

b. Definition of “high-risk asset” and “high-risk trading strategy”.

Section __.8(c) of the proposed rule defines “high-risk asset” and “high-risk trading strategy” for purposes of § __.8's proposed limitations on permitted trading activities. Section

²¹¹ See proposed rule § __.8(b)(2). As part of maintaining and enforcing information barriers, a banking entity should have processes to review, test, and modify information barriers on a continuing basis. In addition, banking entities should have ongoing monitoring to maintain and to enforce information barriers, for example by identifying whether such barriers have not prevented unauthorized information sharing and addressing instances in which the barriers were not effective. This may require both remediating any identified breach as well as updating the information barriers to prevent further breaches, as necessary. Periodic assessment of the effectiveness of information barriers and periodic review of the written policies and procedures are also important to the maintenance and enforcement of effective information barriers and reasonably designed policies and procedures. Such assessments can be done either (i) internally by a qualified employee or (ii) externally by a qualified independent party.

²¹² See proposed rule § __.8(b)(2).

²¹³ In addition, if a conflict occurs to the detriment of a client, customer, or counterparty despite an information barrier, the Agencies would also expect the banking entity to review the effectiveness of its information barrier and make adjustments, as necessary, to avoid future occurrences, or review whether such information barrier is appropriate for that type of conflict.

___8(c)(1) defines a “high-risk asset” as an asset or group of assets that would, if held by the banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail. Section ___8(c)(2) defines a “high-risk trading strategy” as a trading strategy that would, if engaged in by the banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail.²¹⁴

c. Request for comment.

The Agencies request comment on the proposed limitations on permitted trading activities. In particular, the Agencies request comment on the following questions:

Question [•]. Is the manner in which the proposed rule implements the limitations of section 13(d)(2) of the BHC Act effective and sufficiently clear? If not, what alternative would be more effective and/or clearer?

Question [•]. Is the proposed rule’s definition of material conflict of interest effective and sufficiently clear? If not, what alternative would be more effective and/or clearer?

Question [•]. Is the proposed definition of material conflict of interest over- or under-inclusive? If so, how should the definition be broader or narrower? Is there an alternative definition that would be appropriate? If so, what definition? Why would that alternative definition better define material conflict of interest for purposes of implementing section 13 of the BHC Act?

Question [•]. Would the proposed definition of material conflict of interest have any unintended chilling effect on underwriting, market making, risk-mitigating hedging or other permitted activities? If so, what alternatives might limit such an effect?

Question [•]. Would the proposed definition of material conflict of interest lead to unintended consequences? If so, what unintended consequences and why? Please suggest modifications to the proposed definition that would mitigate those consequences.

Question [•]. Is it likely that the proposed definition of material conflict of interest would anticipate all future material conflicts of interest, particularly as the financial markets evolve and change? If not, what alternative definition would better anticipate future material conflicts of interest?

Question [•]. Does the proposed rule provide sufficient guidance for determining when a conflict of interest would be material? If not, what additional detail should be provided? Should materiality be defined? If so, how?

Question [•]. Are there transactions, classes or types of transactions, or activities inherent in underwriting, market-making, risk-mitigating hedging or other permitted activities that should

²¹⁴ The Agencies note that a banking entity subject to proposed Appendix C must implement a compliance program that includes, among other things, policies and procedures that explain how the banking entity monitors and prohibits exposure to high-risk assets and high-risk trading strategies, and identifies a variety of assets and strategies (e.g., assets or strategies with significant embedded leverage).

not be prohibited but may be captured by the proposed definition of material conflict of interest? If so, what transactions and activities? Should they be permitted under the proposed rule? If so, why and under what conditions, if any? Conversely, are there transactions or activities that would be permitted under the proposed rule that should be prohibited? If so, what transactions and activities? Why should they be prohibited under the proposed rule?

Question [•]. Please discuss the inherent conflicts of interest that arise from bona fide underwriting, market making-related activity, risk-mitigating hedging, or any other permitted activity, and provide specific examples of such inherent conflicts. Do you believe that such conflicts ever result in a materially adverse interest between a banking entity and a client, customer, or counterparty? How should the proposal address inherent conflicts that result from otherwise-permitted activities?

Question [•]. Is the manner in which the proposed rule permits the use of disclosure in certain cases to address and mitigate conflicts of interest appropriate? Why or why not? Should additional or alternative requirements be placed on the use of disclosure to address and mitigate conflicts? If so, what additional and alternative requirements, and why? Is the level of detail and specificity required by the proposed rule with respect to disclosure appropriate? If not, what alternative level of detail and specificity would be more appropriate?

Question [•]. Should the proposed rule require written disclosure to a client, customer, or counterparty regarding a material conflict of interest? If so, please explain why written disclosure should be required. Are there certain circumstances where written disclosure should be required, but others where oral disclosure should be sufficient? For example, should oral disclosure be permitted for transactions in certain fast-moving markets or transactions with sophisticated clients, customers, or counterparties? If oral disclosure is permitted under certain circumstances, should subsequent written disclosure be required? Please explain.

Question [•]. Should the proposed rule provide further detail regarding the types of conflicts of interest that cannot be addressed and mitigated through disclosure? If so, what type of additional detail would be helpful, and why? Should the proposed rule enumerate an exhaustive or non-exhaustive list of conflicts that cannot be addressed and mitigated through disclosure? If so, what conflicts should that list include, and why?

Question [•]. Should the proposed rule provide further detail regarding the frequency at which disclosure must be made? Should general disclosure be permitted for certain types of transactions, classes of transactions, or activities? For example, should a banking entity be permitted to make a one-time, written disclosure to a client, customer, or counterparty prior to engaging in a certain type of transaction or activity? Should general disclosure be permitted for certain types of clients, customers, or counterparties (e.g., highly sophisticated parties)? Please explain why specific disclosure (i.e., prior to each transaction, class of transaction, or activity) would not be necessary under the identified circumstances. Should the proposed rule permit a client, customer, or counterparty to waive a material conflict of interest under certain circumstances? If so, under what circumstances would a waiver approach be appropriate? Please explain.

Question [•]. Should the proposed definition of material conflict of interest deem certain potential conflicts of interest to not be material conflicts of interest if a banking entity establishes, maintains, and enforces policies and procedures (other than information barriers) reasonably designed to prevent transactions, classes of transactions, or activities that would involve or result in a material conflict of interest? If so, for what types of potential conflicts? What policies and procedures would be appropriate? How would this approach be consistent with the purpose and language of the statute? Should such policies and procedures only be considered effective if they prevent the banking entity from receiving an advantage to the disadvantage of the client, customer, or counterparty?

Question [•]. Are there particular types of clients, customers, or counterparties for whom disclosure of a material conflict of interest should not be required under the proposal? Please identify the types of clients, customers, or counterparties for whom disclosure might not be necessary and explain. Why might disclosures be useful for some clients, customers, or counterparties, but not others? Please explain. What characteristics should a firm use in determining whether or not a client, customer, or counterparty needs a particular disclosure?

Question [•]. Are there additional steps that a banking entity that seeks to manage conflicts of interest through the use of disclosure should be required to take with regard to disclosure? If so, what steps?

Question [•]. Are there circumstances in which disclosure might be impracticable or ineffective? If so, what circumstances, and why?

Question [•]. Is the manner in which the proposed rule permits the use of information barriers to address and mitigate conflicts of interest appropriate? Why or why not? Should additional or alternative requirements be placed on the use of information barriers to address and mitigate conflicts? If so, what additional and alternative requirements, and why?

Question [•]. Should the proposed rule mandate the use of other means of managing potential conflicts of interest? If so, what specific means should be considered? How effective are any such methods as currently used? Can such methods be circumvented? If so, in what ways?

Question [•]. What burdens or costs might be associated with the disclosure-related or information barrier-related requirements contained in the proposed definition of material conflict of interest? How might these burdens or costs be eliminated or reduced in a manner consistent with the purpose and language of section 13 of the BHC Act?

Question [•]. Are there specific transactions, classes of transactions or activities that should be managed through consent? If so, what transactions or activities, and why? What form of consent should be required? What level of detail should any such consent include? Should consent only apply to certain conflicts and not others? If so, which conflicts? Are there circumstances in which obtaining consent might be impracticable or ineffective? Should consent be limited to certain types of clients, customers, or counterparties? If so, which clients, customers, or counterparties? Are there certain types of clients, customers, or counterparties for whom consent would never be sufficient? Are there additional steps that a banking entity that

seeks to manage conflicts of interest through the use of consent should be required to take? Please specify such steps.

Question [•]. What is the potential relationship between, and interplay of, the proposed rule and Section 621 of the Dodd-Frank Act regarding conflicts of interest relating to certain securitizations which contains a prohibition on material conflicts of interest?

Question [•]. Should the proposed rule provide for specific types of procedures that would be more effective in managing and mitigating conflicts of interest than others? Do banking entities currently use certain procedures that effectively manage and mitigate material conflicts of interest? If so, please describe such procedures and explain why such procedures are effective. Is the proposed rule consistent with such procedures? Why or why not? What are the costs and benefits of modifying your current procedures in response to the proposed rule?

Question [•]. Is the proposed rule's definition of a high-risk asset effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should the proposed rule specify particular assets that are deemed high-risk per se? If so, what assets and why?

Question [•]. Is the proposed rule's definition of a high-risk trading strategy effective and sufficient clear? If not, what alternative would be more effective and/or clearer? Should the proposed rule specify particular trading strategies that are deemed high-risk per se? If so, what trading strategies and why?

C. Subpart C - Covered Fund Activities and Investments

As noted above, except as otherwise permitted, section 13(a)(2) of the BHC Act prohibits a banking entity from acquiring or retaining any ownership in, or acting as sponsor to, a covered fund.²¹⁵ Subpart C of the proposed rule applies those portions of section 13 of the BHC Act that operate as a prohibition or restriction on a banking entity's ability, as principal, directly or indirectly, to acquire or retain an ownership interest in, act as sponsor to, or have certain relationships with, a covered fund. Subpart C also implements the permitted activity and investment authorities provided for under section 13(d)(1) of the BHC Act related to covered fund activities and investments, as well as the rule of construction related to the sale and securitization of loans under section 13(g)(2) of that Act. Additionally, subpart C contains a discussion of the internal controls, reporting and recordkeeping requirements applicable to covered fund activities and investments, and incorporates by reference the minimum compliance standards for banking entities contained in subpart D of the proposed rule, as well as Appendix C, to the extent applicable.

1. Section .10: Prohibition of acquisition or retention of ownership interests in, and certain relationships with, a covered fund.

²¹⁵ See 12 U.S.C. 1851(a)(1)(B).

Section __.10 of the proposed rule defines the scope of the prohibition on acquisition or retention of ownership interests in, and certain relationships with, a covered fund, as well as defines a number of key terms related to such prohibition.

a. Prohibition regarding covered fund activities and investments.

Section __.10(a) of the proposed rule implements section 13(a)(1)(B) of the BHC Act and prohibits a banking entity from, as principal, directly or indirectly, acquiring or retaining an equity, partnership, or other ownership interest in, or acting as sponsor to, a covered fund, unless otherwise permitted under subpart C of the proposed rule.²¹⁶ This prohibition reflects the statute's purpose and effect of limiting a banking entity's ability to invest in or have exposure to a covered fund.

The Agencies note that the general prohibition in § __.10(a) of the proposed rule applies solely to a banking entity's acquisition or retention of an ownership interest in or acting as sponsor to a covered fund "as principal, directly or indirectly."²¹⁷ As such, the proposed rule would not prohibit the acquisition or retention of an ownership interest (including a general partner or membership interest) in a covered fund: (i) by a banking entity in good faith in a fiduciary capacity, except where such ownership interest is held under a trust that constitutes a company as defined in section (2)(b) of the BHC Act; (ii) by a banking entity in good faith in its capacity as a custodian, broker, or agent for an unaffiliated third party; (iii) by a "qualified plan," as that term is defined in section 401 of the Internal Revenue Code of 1956 (26 U.S.C. 401), if the ownership interest would be attributed to a banking entity solely by operation of section 2(g)(2) of the BHC Act; or (iv) by a director or employee of a banking entity who acquires the interest in his or her personal capacity and who is directly engaged in providing advisory or other services to the covered fund, unless the banking entity, directly or indirectly, extended credit for the purpose of enabling the director or employee to acquire the ownership interest in the fund and the credit was used to acquire such ownership interest in the fund.

Among other things, § __.10(b) of the proposed rule defines the term "covered fund."²¹⁸ This definition explains the universe of entities to which the prohibition contained in § __.10(a) applies unless the activity is specifically permitted under an available exemption contained in subpart C of the proposed rule. Other related terms, including "ownership interest," "prime brokerage transaction," "sponsor," and "trustee," are in turn defined in §§ __.10(b)(2) through __.10(b)(6) of the proposed rule.

b. "Covered fund" and related definitions.

i. Definition of "covered fund".

²¹⁶ See proposed rule § __.10(a).

²¹⁷ The Agencies note that this language is intended to prevent a banking entity from evading the restrictions contained in section 13(a)(1)(B) of the BHC Act on acquiring or retaining an ownership interest in a covered fund.

²¹⁸ See proposed rule § __.10(b)(1). The term banking entity, which is discussed above in Part III.A.2 of this Supplementary Information, is defined in § __.2(e).

Section 13(h)(2) of the BHC Act defines the terms “hedge fund” and “private equity fund” to mean “any issuer that would be an investment company, as defined in the [Investment Company Act], but for section 3(c)(1) or 3(c)(7) of that Act,” or such similar funds as the Agencies may by rule determine.²¹⁹ Given that the statute defines a “hedge fund” and “private equity fund” synonymously, the proposed rule implements this statutory definition by combining the terms into the definition of a “covered fund.”²²⁰

Sections 3(c)(1) and 3(c)(7) of the Investment Company Act are exclusions from the definition of “investment company” in that Act and are commonly relied on by a wide variety of entities that would otherwise be covered by the broad definition of “investment company” contained in that Act. As a result, the statutory definition in section 13(h)(2) of the BHC Act could potentially include within its scope many entities and corporate structures that would not usually be thought of as a “hedge fund” or “private equity fund.” For instance, joint ventures, acquisition vehicles, certain wholly-owned subsidiaries, and other widely-utilized corporate structures typically rely on the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act. These types of entities are generally not used to engage in investment or trading activities. Additionally, as noted in Part II.H of this Supplementary Information, certain securitization vehicles may be included in this definition.

The proposed rule follows the scope of the statutory definition by covering an issuer only if it would be an investment company, as defined in the Investment Company Act, but for section 3(c)(1) or 3(c)(7) of that Act.²²¹ Additionally, the proposed rule incorporates the statutory application of the rule to “such similar funds as the Agencies may determine by rule as provided in section 13(b)(2) of the BHC Act.”²²² The Agencies have proposed to include as “similar funds” a commodity pool,²²³ as well as the foreign equivalent of any entity identified as a

²¹⁹ 12 U.S.C. 1851(h)(2). Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, in relevant part, provide two exclusions from the definition of “investment company” for, as appropriate, (1) any issuer whose outstanding securities are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities (other than short-term paper), or (2) any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time proposes to make a public offering of such securities. See 15 U.S.C. 80a-3(c)(1) and (c)(7).

²²⁰ See proposed rule § __.10(b)(1).

²²¹ See proposed rule § __.10(b)(1)(i). Under the proposed rule, if an issuer (including an issuer of asset-backed securities) may rely on another exclusion or exemption from the definition of “investment company” under the Investment Company Act other than the exclusions contained in section 3(c)(1) or 3(c)(7) of that Act, it would not be considered a covered fund, as long as it can satisfy all of the conditions of an alternative exclusion or exemption for which it is eligible.

²²² 12 U.S.C. 1851(b)(2).

²²³ “Commodity pool” is defined in the Commodity Exchange Act to mean any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any: (i) commodity for future delivery, security futures product, or swap; (ii) agreement, contract, or transaction described in section 2(c)(2)(C)(i) or 2(c)(2)(D)(i) of the Commodity Exchange Act; (iii) commodity option authorized under section 4c of the Commodity Exchange Act; or (iv) leverage transaction authorized under section 23 of the Commodity Exchange Act. See 7 U.S.C. 1a(10).

“covered fund.”²²⁴ These entities have been included in the proposed rule as “similar funds” given that they are generally managed and structured similar to a covered fund, except that they are not generally subject to the Federal securities laws due to the instruments in which they invest or the fact that they are not organized in the United States or one or more States.

ii. Definition of “ownership interest”.

The proposed rule defines “ownership interest” in order to make clear the scope of section 13(a)(1)(B) of the BHC Act and § __.10(a)’s prohibition on a banking entity acquiring or retaining any equity, partnership, or other ownership interest in a covered fund. The definition of ownership interest includes a description of what interests constitute an ownership interest, as well as an exclusion from the definition of ownership interest for certain instruments.²²⁵ The proposed rule defines ownership interest to mean, with respect to a covered fund, any equity, partnership, or other similar interest (including, without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate, or other similar interest) in a covered fund, whether voting or nonvoting, as well as any derivative of such interest. This definition focuses on the attributes of the interest and whether it provides a banking entity with economic exposure to the profits and losses of the covered fund, rather than its form. To the extent that a debt security or other interest of a covered fund exhibits substantially the same characteristics as an equity or other ownership interest (e.g., provides the holder with voting rights, the right or ability to share in the covered fund’s profits or losses, or the ability, directly or pursuant to a contract or synthetic interest, to earn a return based on the performance of the fund’s underlying holdings or investments), the Agencies could consider such instrument an ownership interest as an “other similar instrument.”

Many banking entities that serve as investment adviser or commodity trading advisor to a covered fund are compensated for services they provide to the fund through receipt of so-called “carried interest.” In recognition of the manner in which such compensation is traditionally provided, the proposed rule also clarifies that an ownership interest with respect to a covered fund does not include an interest held by a banking entity (or an affiliate, subsidiary or employee thereof) in a covered fund for which the banking entity (or an affiliate, subsidiary or employee thereof) serves as investment manager, investment adviser or commodity trading advisor, so long as: (i) the sole purpose and effect of the interest is to allow the banking entity (or the affiliate, subsidiary or employee thereof) to share in the profits of the covered fund as performance compensation for services provided to the covered fund by the banking entity (or the affiliate, subsidiary or employee thereof), provided that the banking entity (or the affiliate, subsidiary or employee thereof) may be obligated under the terms of such interest to return profits previously received; (ii) all such profit, once allocated, is distributed to the banking entity (or the affiliate,

²²⁴ See proposed rule § __.10(b)(1)(iii). The proposed rule makes clear that any issuer, as defined in section 2(a)(22) of the Investment Company Act, (15 U.S.C. 80a-2(a)(22)), that is organized or offered outside of the United States, would qualify as a covered fund if, were it organized or offered under the laws, or offered for sale or sold to a resident, of the United States or of one or more States, it would be either: (i) an investment company, as defined in the Investment Company Act, but for section 3(c)(1) or 3(c)(7) of that Act; (ii) a commodity pool; or (iii) any such similar fund as the appropriate Federal banking agencies, the SEC, and the CFTC may determine, by rule, as provided in section 13(b)(2) of the BHC Act.

²²⁵ See proposed rule § __.10(b)(3).

subsidiary or employee thereof) promptly after being earned or, if not so distributed, the reinvested profit of the banking entity (or the affiliate, subsidiary or employee thereof) does not share in the subsequent profits and losses of the covered fund; (iii) the banking entity (or the affiliate, subsidiary or employee thereof) does not provide funds to the covered fund in connection with acquiring or retaining this carried interest; and (iv) the interest is not transferable by the banking entity (or the affiliate, subsidiary or employee thereof) except to an affiliate or subsidiary.²²⁶ The proposed rule therefore permits a banking entity to receive an interest as performance compensation for services provided by it or one of its affiliates, subsidiaries, or employees to a covered fund, but only if the enumerated conditions are met.

iii. Definition of “prime brokerage transaction”.

Section 13(f)(3) of the BHC Act permits a banking entity to enter into a prime brokerage transaction with a covered fund in which a covered fund managed, organized, or sponsored by such banking entity (or an affiliate or subsidiary thereof) has taken an ownership interest.²²⁷ However, section 13 of the BHC Act does not define what qualifies as a prime brokerage transaction. In order to provide clarity regarding the types of services and relationships that are permitted as a prime brokerage transaction, the proposed rule defines a “prime brokerage transaction” to mean one or more products or services provided by a banking entity to a covered fund, such as custody, clearance, securities borrowing or lending services, trade execution, or financing, data, operational, and portfolio management support.²²⁸

iv. Definition of “sponsor” and “trustee”.

The proposed rule defines “sponsor” in the same manner as section 13(h)(5) of the BHC Act.²²⁹ Section __.10(b)(5) of the proposed rule defines the term “sponsor” as an entity that: (i) serves as a general partner, managing member, trustee, or commodity pool operator of a covered fund; (ii) in any manner selects or controls (or has employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or (iii) shares with a covered fund, for the corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.²³⁰

The definition of “sponsor” contained in section 13(h)(5) of the BHC Act focuses on the ability to control the decision-making and operational functions of the fund. In keeping with this focus, the proposed rule defines the term “trustee” (which is a part of the definition of “sponsor”) to exclude trustee that does not exercise investment discretion with respect to a covered fund, including a directed trustee, as that term is used in section 403(a)(1) of the Employee’s Retirement Income Security Act (29 U.S.C. 1103(a)(1)). The proposed rule provides that a

²²⁶ See proposed rule § __.10(b)(3)(ii).

²²⁷ See 12 U.S.C. 1851(f)(3).

²²⁸ See proposed rule § __.10(b)(4).

²²⁹ See 12 U.S.C. 1851(h)(5).

²³⁰ See proposed rule § __.10(b)(5).

“trustee” includes any banking entity that directs a directed trustee, or any person who possesses authority and discretion to manage and control the assets of the covered fund.²³¹

v. Request for comment

The Agencies request comment on the proposed rule’s approach to defining the terms covered fund, ownership interest, and other related terms. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule’s approach to applying section 13 of the BHC Act’s restrictions related to covered fund activities and investments to those instances where a banking entity acts “as principal or beneficial owner” effective? If not, why? What alternative approach might be more effective in light of the language and purpose of the statute?

Question [•]. Does the proposed rule effectively address the circumstances under which an investment by a director or employee of a banking entity in a covered fund would be attributed to a banking entity? If not, why? What alternative might be more effective?

Question [•]. Does the proposed rule’s definition of “covered fund” effectively implement the statute? What alternative definitions might be more effective in light of the language and purpose of the statute?

Question [•]. Is specific inclusion of commodity pools within the definition of “covered fund” effective and consistent with the language and purpose of the statute? Why or why not?

Question [•]. The proposed definition of “sponsor” focuses on “the ability to control the decision-making and operational functions of the fund.” In the securitization context, is this an appropriate manner to determine the identity of the sponsor? If not, what factors should be used to determine the identity of the sponsor in the securitization context for purposes of the proposed rule and why? Is the definition of “sponsor” set forth in the SEC’s Regulation AB²³² an appropriate party to treat as sponsor for purposes of the proposed rule? Is additional guidance necessary with respect to how the proposed definition of “sponsor” should be applied to a securitization transaction?

Question [•]. Should the application of the proposed definition of “sponsor” mean that the servicer or investment manager in a securitization transaction would be considered the sponsor for purposes of the proposed rule? What impact would this interpretation of the proposed definition have on existing securitizations?

Question [•]. Should the definition of “covered fund” focus on the characteristics of an entity rather than whether it would be an investment company but for section 3(c)(1) or 3(c)(7) of the Investment Company Act? If so, what characteristics should be considered and why? Would a definition focusing on an entity’s characteristics rather than its form be consistent with the language and purpose of the statute?

²³¹ See proposed rule § __.10(b)(6)(ii).

²³² See 17 CFR 229.1101(l).

Question [•]. Instead of adopting a unified definition of “covered fund” for those entities included under section 13(h)(2) of the BHC Act, should the Agencies consider having separate definitions for “hedge fund” and “private equity fund”? If so, which definitions and why?

Question [•]. Should the Agencies consider using the authority provided under section 13(d)(1)(J) of the BHC Act to exempt the acquisition or retention of an ownership interest in a covered fund with certain attributes or characteristics, including, for example: (i) a performance fee or allocation to an investment manager’s equity account calculated by taking into account income and realized and unrealized gains; (ii) borrowing an amount in excess of one-half of its total capital commitments or has gross notional exposure in excess of twice its total capital commitments; (iii) sells securities or other assets short; (iv) has restricted or limited investor redemption rights; (v) invests in public and non-public companies through privately negotiated transactions resulting in private ownership of the business; (vi) acquires the unregistered equity or equity-like securities of such companies that are illiquid as there is no public market and third party valuations are not readily available; (vii) requires holding those investments long-term; (viii) has a limited duration of ten years or less; or (ix) returns on such investments are realized and the proceeds of the investments are distributed to investors before the anticipated expiration of the fund’s duration? Which, if any, of these characteristics are appropriate to describe a hedge fund or private equity fund that should be considered a covered fund for purposes of this rule? Are there any other characteristics that would be more appropriate to describe a covered fund? If so, which characteristics and why?

Question [•]. Is specific inclusion of certain non-U.S. entities as a “covered fund” under § __.10(b)(1)(iii) of the proposed rule necessary, or would such entities already be considered to be a “covered fund” under § __.10(b)(1)(i) of the proposed rule? If so, why? Does the proposed rule’s language on non-U.S. entities correctly describe those non-U.S. entities, if any, that should be included in the definition of “covered fund”? Why or why not? What alternative language would be more effective? Should we define non-U.S. funds by reference to the following structural characteristics: whether they are limited in the number or type of investors; whether they operate without regard to statutory or regulatory requirements relating to the types of instruments in which they may invest or the degree of leverage they may incur? Why or why not?

Question [•]. Are there any entities that are captured by the proposed rule’s definition of “covered fund,” the inclusion of which does not appear to be consistent with the language and purpose of the statute? If so, which entities and why?

Question [•]. Are there any entities that are not captured by the proposed rule’s definition of “covered fund,” the exclusion of which does not appear to be consistent with the language and purpose of the statute? If so, which entities and why?

Question [•]. Do the proposed rule’s definitions of “covered fund” and/or “ownership interest” pose unique concerns or challenges to issuers of asset-backed securities and/or securitization vehicles? If so, why? Do certain types of securitization vehicles (trusts, LLCs, etc.) typically issue asset-backed securities which would be included in the proposed definition of ownership interest? What would be the impact of the application of the proposed rules to these securitization vehicles? Are certain asset classes (collateralized debt obligations, future

flows, corporate debt repackages, etc.) more likely to be impacted by the proposed definition of "covered fund" because the issuer cannot rely on an exemption other than 3(c)(1) or 3(c)(7) of the Investment Company Act?

Question [•]. How many existing issuers of asset-backed securities would be included in the proposed definition of "covered fund?" What would be the legal and economic impact of the proposed rule on holders of asset-backed securities issued by existing securitization vehicles that would be included in the proposed definition of covered fund?

Question [•]. Are there entities that issue asset-backed securities (as defined in Section 3(a) of the Exchange Act) that should be exempted from the requirements of the proposed rule? How would such an exemption promote and protect the safety and soundness of the banking entity and the financial stability of the United States as required by section 13(d)(1)(J) of the BHC Act?

Question [•]. Since certain existing asset-backed securities may have a term that exceeds the conformance or extended transition periods provided for under section 13(c) of the BHC Act, should the Agencies consider using the authority contained in section 13(d)(1)(J) of that Act to exclude those existing asset-backed securities from the proposed definition of "ownership interest" and/or should the rule permit a banking entity to acquire or retain an ownership interest in existing asset-backed issuers? If so, how would either approach be consistent with the language and purpose of the statute?

Question [•]. Many issuers of asset-backed securities have features and structures that resemble some of the features of hedge funds and private equity funds (e.g., CDOs are managed by an investment adviser that has the discretion to choose investments, including investments in securities). If the proposed definition of "covered fund" were to exempt any entity issuing asset-backed securities, would this allow for interests in hedge funds or private equity funds to be structured as asset-backed securities and circumvent the proposed rule? If this approach is taken, how should the proposal address this concern?

Question [•]. Are the structural similarities between an entity that issue asset-backed securities and hedge funds and private equity funds of sufficient concern that the Agencies should not exclude any entity that issues asset-backed securities from the definition of covered fund?

Question [•]. Should entities that rely on a separate exclusion from the definition of investment company other than sections 3(c)(1) or 3(c)(7) of the Investment Company Act be included in the definition of "covered fund"? Why or why not?

Question [•]. Do the proposed rule's definitions of "ownership interest" and "carried interest" effectively implement the statute? What alternative definitions might be more appropriate in light of the language and purpose of the statute? Are there other types of instruments that should be included or excluded from the definition of "ownership interest"? Does the proposed definition of ownership interest capture most interests that are typically viewed as ownership interests? Is the proposed rule's exemption of carried interest from the definition of ownership interest with respect to a covered fund appropriate? Does the exemption adequately address existing compensation arrangements and the way in which a banking entity

becomes entitled to carried interest? Is it consistent with the current tax treatment of these arrangements?

Question [•]. In the context of asset-backed securities, the distinction between debt and equity may be complicated (e.g., trust certificates issued in a residential mortgage backed security transaction) and the legal, accounting and tax treatment may differ for the same instrument. Is guidance necessary with respect to the application of the definition of ownership interest for asset-backed securitization transactions?

Question [•]. In many securitization transactions, the residual interest represents the “equity” in the transaction. As this often constitutes the portion of the securitization transaction with the most risk, because it may absorb any losses experienced by the underlying assets before any other interests issued by the securitization vehicle, should the Agencies instead use their authority under section 13(d)(1)(J) of the BHC Act to exempt the buying and selling of any ownership interest in a securitization vehicle that is a covered fund other than the residual interest?

Question [•]. For purposes of limiting either an exclusion for issuers of asset-backed securities from the proposed definition of “covered fund” and/or an exclusion of asset-backed securities from the proposed definition of “ownership interest,” what definition of asset-backed security most effectively implements the language of section 13 of the BHC Act? Section 3(a)(77) of the Exchange Act and the SEC’s Regulation AB²³³ provide two possible definitions. Is either of these definitions sufficient, and if so why? If one of the definitions is too narrow, what additional entities/securities should be included and why? If one of the definitions is too broad, what entities/securities should be excluded and why? Would some other definition of asset-backed security be more consistent with the language and purpose of section 13 of the BHC Act?

Question [•]. Are there special concerns raised by not including as an ownership interest the residual interests in a securitization vehicle? Should the Agencies instead exempt the buying and selling of any ownership interest in a securitization vehicle that is a covered fund other than the residual interest?

Question [•]. Should the legal form of a beneficial interest be a determining factor for deciding whether a beneficial interest is an “ownership interest”? For example, should pass-through trust certificates issued as part of a securitization transaction be excluded from the definition of “ownership interest”? Should the definition of ownership interest explicitly include debt instruments with equity features (e.g., voting rights, profit participations, etc.)?

Question [•]. How should the proposed rule address those instances in which both debt and equity interests are issued, and the debt interests receive all of the economic benefits and all of the control rights? Should the debt interests (other than the residual interest) be counted as ownership interests even though they are not legally ownership and do not receive any profit participation? Should the equity interests be counted as ownership interests even though the

²³³ See 17 CFR 229.1101(c).

holder does not receive economic benefits or have any control rights? Should the residual interest be considered the only "ownership interest" for purposes of the proposed rule? Should mezzanine interests that lack both control rights and profit participation be considered an ownership interest? If the mezzanine interests obtain control rights (because more senior classes have been repaid), should they become "ownership interests" at that time for purposes of the proposed rule? If both debt and equity interests are counted as ownership interests, how should percentages of ownership interests be calculated when the units of measurement do not match (e.g., a single trust certificate, a single residual certificate with no face value and multiple classes of currency-denominated notes)?

Question [•]. Does the proposed rule's definition of "prime brokerage transaction" effectively implement the statute? What other types of transactions or services, if any, should be included in the definition? Should any types of transactions or services be excluded from the definition? Would an alternative definition be more effective, and if so, why?

Question [•]. Do the proposed rule's definitions of "sponsor" and "trustee" effectively implement the statute? Is the exclusion of "directed trustee" from the definition of "trustee" appropriate?

Question [•]. Do the proposed rule's other definitions in § __.10(b) effectively implement the statute? What alternative definitions might be more effective in light of the language and purpose of the statute? Are additional definitions needed, and if so, what definition(s)?

2. Section __.11: Permitted organizing and offering of a covered fund.

Section __.11 of the proposed rule implements section 13(d)(1)(G) of the BHC Act and permits a banking entity to organize and offer a covered fund, including acting as sponsor of the fund, if certain criteria are met.²³⁴ This exemption is designed to permit a banking entity to be able to engage in certain traditional asset management and advisory businesses in compliance with section 13 of the BHC Act.²³⁵

a. Required criteria for permitted organizing and offering of covered funds.

Section __.11 of the proposed rule provides for and describes the conditions that must be met in order to enable a banking entity to qualify for the exemption to organize and offer a covered fund.²³⁶ These conditions include: (i) the banking entity must provide bona fide trust, fiduciary, investment advisory, or commodity trading advisory services;²³⁷ (ii) the covered fund must be organized and offered only in connection with the provision of bona fide trust, fiduciary,

²³⁴ See proposed rule § __.11.

²³⁵ 156 Cong. Rec. S5889 (daily ed. July 15, 2010) (statement of Sen. Hagan).

²³⁶ See proposed rule §§ __.11(a) – (h).

²³⁷ While section 13(d)(1)(G) of the BHC Act does not explicitly mention "commodity trading advisory services," the Agencies have proposed to include commodity pools within the definition of "covered fund" and commodity trading advisory services in the same way as investment advisory services because commodity trading advisory services are the functional equivalent of investment advisory services to commodity pools.

investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity; (iii) the banking entity may not acquire or retain an ownership interest in the covered fund except as permitted under subpart C of the proposed rule; (iv) the banking entity must comply with the restrictions governing relationships with covered funds under § __.16 of the proposed rule; (v) the banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests; (vi) the covered fund, for corporate, marketing, promotional, or other purposes, (A) may not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof), and (B) may not use the word “bank” in its name; (vii) no director or employee of the banking entity may take or retain an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund; and (viii) the banking entity must (A) clearly and conspicuously disclose, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund’s offering documents) the enumerated disclosures contained in § __.11(h) of the proposed rule, and (B) comply with any additional rules of the appropriate Agency or Agencies, designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the banking entity.²³⁸ These requirements are explained in detail below.

i. Bona fide services.

Section __.11(a) of the proposed rule requires that, in order to qualify for the exemption related to organizing and offering a covered fund, a banking entity provide bona fide trust, fiduciary, investment advisory, or commodity trading advisory services.²³⁹ Banking entities provide a wide range of customer-oriented services which may qualify as bona fide trust, fiduciary, investment advisory, or commodity trading advisory services.²⁴⁰ Additionally, depending on the type of banking entity that conducts the activity or provides the service, variations in the precise services involved may occur. For example, a national bank and an SEC-registered investment adviser may provide substantially similar investment advisory services to clients, but be subject to different statutory and regulatory requirements. In recognition of potential variations in services and functional regulation, the proposed rule does not specify what services would qualify as “bona fide trust, fiduciary, investment advisory, or commodity trading advisory services” under § __.11(a) of the proposed rule. Instead, the proposed rule largely mirrors the statutory language of section 13(d)(1)(G)(i) of the BHC Act and reflects the intention that so long as a banking entity provides trust, fiduciary, investment advisory, or commodity trading advisory services in compliance with relevant statutory and regulatory requirements, the requirement contained in § __.11(a) of the proposed rule would generally be deemed to be satisfied.

ii. “Customers of such services” requirement.

²³⁸ See *id.* at § __.11(a) – (h). The Agencies are not proposing any such additional rules at this time, although they may do so in the future.

²³⁹ See 12 U.S.C. 1851(d)(1)(G)(i); proposed rule § __.11(a).

²⁴⁰ See, e.g., 12 U.S.C. 1843(c)(4), (c)(8), (k), 12 CFR 225.28(b)(5) and (6), 12 CFR 225.86, 12 CFR 225.125 (with respect to a bank holding company); 12 U.S.C. 24 (Seventh), 92a, 12 CFR Part 9 (with respect to a national bank); 12 U.S.C. 1831a, 12 CFR Part 362 (with respect to a state nonmember bank).

Section 13(d)(1)(G)(ii) of the BHC Act requires that a banking entity organize and offer a covered fund “only in connection with” the provision of qualified services to persons that are customers of such services of the banking entity.²⁴¹ Section __.11(b) of the proposed rule implements the statute and reflects the statutory requirement that there are two independent conditions contained in section 13(d)(1)(G)(ii) of the BHC Act: (i) a covered fund must be organized and offered in connection with bona fide trust, fiduciary, investment advisory, or commodity trading advisory services, and (ii) the banking entity providing those services may offer the covered fund only to persons that are customers of those services of the banking entity.²⁴² Requiring a customer relationship in connection with organizing and offering a covered fund helps to ensure that a banking entity is engaging in the covered fund activity for others and not on the banking entity’s own behalf.²⁴³

Section 13(d)(1)(G)(ii) of the BHC Act does not explicitly require that the customer relationship be pre-existing. Accordingly, the proposed rule provides that it may be established through or in connection with the banking entity’s organization and offering of a covered fund, so long as that fund is a manifestation of the provision by the banking entity of bona fide trust, fiduciary, investment advisory or commodity trading advisory services to the customer. This application of the customer requirements is consistent with the manner in which trust, fiduciary, investment advisory, and commodity trading advisory services are provided by banking entities. Historically, banking entities have raised capital commitments for covered funds from existing customers as well as individuals or entities that have no pre-existing relationship with the banking entity.

Banking entities commonly organize and offer funds to customers of the banking entity’s trust, fiduciary, and investment advisory or commodity trading advisory services as a way of ensuring the efficient and consistent provision of these services. For example, a person often obtains the investment advisory services of the banking entity by acquiring an interest in a fund organized and offered by the banking entity. This is distinguished from a fund organized and offered by a banking entity for the purpose of itself investing as principal, indirectly through its investment in the fund, in assets held by the fund. Under the proposed rule, a banking entity could, consistent with past practice, provide a covered fund to persons that are customers of such services for purposes of the exemption so long as the fund is organized and offered as a means of providing bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to customers. The banking entity may not organize and offer a covered fund as a means of itself investing in the fund or assets held in the fund.²⁴⁴

²⁴¹ See 12 U.S.C. 1851(d)(1)(G)(ii).

²⁴² See proposed rule § __.11(b).

²⁴³ See 156 Cong. Rec. at S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

²⁴⁴ The proposed rule does not change any requirement imposed by separate statute, regulation, or other law, if applicable. For instance, a banking entity that conducts a private placement of a covered fund pursuant to the SEC’s Regulation D pertaining to private offerings would still be expected to comply with the relevant requirements related to such offering, including the limitations related to the manner in which and types of persons to whom it may offer or sell interests in such fund. See 12 CFR 230.501 et seq.

The Agencies note that a banking entity could, through organizing and offering a covered fund pursuant to the authority contained in § __.11 of the proposed rule that itself makes investments or engages in trading activity, seek to evade the restrictions contained in section 13 of the BHC Act and the proposed rule. In order to address these concerns, the proposed rule provides that a banking entity relying on the authority contained in § __.11 must organize and offer a covered fund pursuant to a credible plan or similar documentation outlining how the banking entity intends to provide advisory or similar services to its customers through organizing and offering such fund.

iii. Compliance with investment limitations.

Section 13(d)(1)(G)(iii) of the BHC Act limits the ability of a banking entity that organizes and offers a covered fund to acquire or retain an ownership interest in that covered fund.²⁴⁵ Separately, other provisions of section 13 of the BHC Act provide independent exemptions which permit a banking entity to acquire or retain an ownership interest in a covered fund.²⁴⁶ Section __.11(c) of the proposed rule incorporates these statutory provisions by prohibiting a banking entity from acquiring or retaining an ownership interest in a covered fund that it organizes and offers except as permitted under subpart C of the proposed rule.²⁴⁷ The limits on a banking entity's ability to invest in a covered fund that it organizes and offers are described in § __.12 of the proposal.

iv. Compliance with section 13(f) of the BHC Act.

Section __.11(d) of the proposed rule requires that the banking entity comply with the limitations on certain relationships with covered funds.²⁴⁸ These limitations apply in several contexts, and are contained in § __.16 of the proposed rule, discussed in detail below. In general, § __.16 of the proposed rule prohibits certain transactions or relationships that would be covered by section 23A of the FR Act, and provides that any permitted transaction is subject to section 23B of the FR Act, in each instance as if such banking entity were a member bank and such covered fund were an affiliate thereof.²⁴⁹

v. No guarantees or insurance of fund performance.

Section __.11(e) of the proposed rule prohibits the banking entity from, directly or indirectly, guaranteeing, assuming or otherwise insuring the obligations or performance of the covered fund or any covered fund in which such covered fund invests.²⁵⁰ This prong implements

²⁴⁵ See 12 U.S.C. 1851(d)(1)(G)(iii).

²⁴⁶ See, e.g., *id.* at 1851(d)(1)(C).

²⁴⁷ See proposed rule § __.11(c).

²⁴⁸ 12 U.S.C. 1851(d)(1)(G)(iv); proposed rule § __.11(d).

²⁴⁹ See Supplementary Information, Part III.C.7.

²⁵⁰ 12 U.S.C. 1851(d)(1)(G)(v); proposed rule § __.11(e).

section 13(d)(1)(G)(iv) of the BHC Act and is intended to prevent a banking entity from engaging in bailouts of a covered fund in which it has an interest.²⁵¹

vi. Limitation on name sharing with a covered fund.

Section __.11(f) of the proposed rule prohibits the covered fund from sharing the same name or a variation of the same name with the banking entity, for corporate, marketing, promotional, or other purposes.²⁵² This section implements section 13(d)(1)(G)(v) of the BHC Act and addresses the concern that name-sharing could undermine market discipline and encourage a banking entity to bail out a covered fund it organizes and offers in order to preserve the entity's reputation.²⁵³ Thus, under § __.11(f) of the proposed rule, a covered fund would be prohibited from sharing the same name or variation of the same name with a banking entity that organizes and offers or serves as sponsor to that fund (or an affiliate or subsidiary of such banking entity). A covered fund would also be prohibited under the proposed rule from using the word "bank" in its name.²⁵⁴

vii. Limitation on ownership by directors and employees.

Section __.11(g) of the proposed rule implements section 13(d)(1)(G)(vii) of the BHC Act. The provision prohibits any director or employee of the banking entity from acquiring or retaining an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund.²⁵⁵ This allows an individual acting as fund manager or adviser and employed by a banking entity to acquire or retain an ownership interest in a covered fund that aligns the manager or adviser's incentives with those of its customers by allowing the individual to have "skin in the game" with respect to a covered fund for which that individual provides management or advisory services (which customers or clients often request).²⁵⁶

The Agencies recognize that director or employee investments in a covered fund may provide an opportunity for a banking entity to evade the limitations regarding the amount or value of ownership interests a banking entity may acquire or retain in a covered fund or funds contained in section 13(d)(4) of the BHC Act and § __.12 of the proposed rule. In order to address this concern, the proposed rule would generally attribute an ownership interest in a covered fund acquired or retained by a director or employee to such person's employing banking entity, if the banking entity either extends credit for the purpose of allowing the director or

²⁵¹ See 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

²⁵² 12 U.S.C. 1851(d)(1)(G)(vi); proposed rule § __.11(f).

²⁵³ 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

²⁵⁴ Similar restrictions on a fund sharing the same name, or variation of the same name, with an insured depository institution or company that controls an insured depository institution or having the word "bank" in its name, have been used previously in order to prevent customer confusion regarding the relationship between such companies and a fund. See, e.g., Bank of Ireland, 82 FED. RES. BULL. 1129 (1996).

²⁵⁵ See 12 U.S.C. 1851(d)(1)(G)(vii); proposed rule § __.11(g).

²⁵⁶ See 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

employee to acquire such ownership interest, guarantees the director or employee's purchase, or guarantees the director or employee against loss on the investment.

viii. Disclosure requirements.

Section __.11(h) of the proposed rule requires that, in connection with organizing and offering a covered fund, the banking entity (i) clearly and conspicuously disclose, in writing, to prospective and actual investors in the covered fund (such as through disclosure in the covered fund's offering documents) that "any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the banking entity and its affiliates or subsidiaries]; therefore, [the banking entity's and its affiliates' or subsidiaries'] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by [the banking entity and its affiliates or subsidiaries] in their capacity as investors in [the covered fund]," and (ii) comply with any additional rules of the appropriate Agency as provided in section 13(b)(2) of the BHC Act designed to ensure that losses in any such covered fund are borne solely by the investors in the covered fund and not by the banking entity.²⁵⁷ The proposed rule also provides, as an additional disclosure requirement related to organizing and offering a covered fund, that a banking entity clearly and conspicuously disclose, in writing, to any prospective and actual investor (such as through disclosure in the covered fund's offering documents): (i) that such investor should read the fund offering documents before investing in the covered fund; (ii) that the "ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity" (unless that happens to be the case); and (iii) the role of the banking entity and its affiliates, subsidiaries, and employees in sponsoring or providing any services to the covered fund. As noted above, the proposed rule clarifies that a banking entity may satisfy the requirements of this prong with respect to a covered fund by making the required disclosures, in writing, in the covered fund's offering documents.²⁵⁸

ix. Request for comment.

The Agencies request comment on the proposed rule's approach with respect to implementing the exemption permitting banking entities to organize and offer a covered fund. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule's approach to implementing the exemption for organizing and offering a covered fund effective? If not, what alternative approach would be more effective and why?

Question [•]. Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

²⁵⁷ 12 U.S.C. 1851(d)(1)(G)(viii); proposed rule § __.11(h).

²⁵⁸ As contemplated in § __.11(a)(8)(ii) of the proposed rule, to the extent that any additional rules are issued to ensure that losses in a covered fund are borne solely by the investors in the covered fund and not by the banking entity, a banking entity would be required to comply with those as well in order to satisfy the requirements of section 13(d)(1)(G)(viii) of the BHC Act.

Question [•]. Is the proposed rule's approach to implementing the scope of bona fide trust, fiduciary, investment advisory and commodity trading advisory services consistent with the statute? If not, what alternative approach would be more effective? Should the scope of such services be broader or, in the alternative, more limited? Are there specific services which should be included but which are not currently under the proposed rule?

Question [•]. Does the proposed rule effectively implement the "customers of such services" requirement? If not, what alternative approach would be more effective and why? Is the proposed rule's approach consistent with the statute? Why or why not? How do banking entities currently sell or provide interests in covered funds? Do banking entities rely on a concept of "customer" by reference to other laws or regulations, and if so, what laws or regulations?

Question [•]. Does the proposed rule effectively and clearly recognize the manner in which banking entities provide trust, fiduciary, investment advisory, or commodity trading advisory services to customers? If not, how should the proposed rule be modified to be more effective or clearer?

Question [•]. Should the Agencies consider adopting a definition of "customer of such services" for purposes of implementing the exemption related to organizing and offering a covered fund? If so, what criteria should be included in such definition? Should the Agencies consider adopting an existing definition related to "customer" and if so, what definitions (for instance, the SEC's "pre-existing, substantive relationship" concept applicable to private offerings under its Regulation D) would provide for effective implementation of the customer requirement in section 13(d)(1)(G) of the BHC Act? If so, why and how? How should the customer requirement be applied in the context of non-U.S. covered funds? Is there an equivalent concept used for such non-U.S. covered fund offerings?

Question [•]. Should the Agencies distinguish between direct and indirect customer relationships for purposes of implementing section 13(d)(1)(G) of the BHC Act? Should the rule differentiate between a customer relationship established by a customer as opposed to a banking entity? If so, why?

Question [•]. Does the proposed rule effectively implement the prohibition on a banking entity guaranteeing or insuring the obligations or performance of certain covered funds? If not, what alternative approach would be more effective, and why?

Question [•]. Does the proposed rule effectively implement the requirement that a banking entity comply with the limitation on certain relationships with a covered fund contained in § __.16 of the proposed rule? If not, what alternative approach would be more effective, and why?

Question [•]. Does the proposed rule effectively implement the prohibition on a covered fund sharing the same name or variation of the same name with a banking entity? If not, what alternative approach would be more effective and why? Should the prohibition on a covered fund sharing the same name be limited to specific types of banking entities (e.g., insured

depository institutions and bank holding companies) or only to the banking entity that organizes and offers the fund, and if so why?

Question [•]. Does the proposed rule effectively implement the limitation on director or employee investments in a covered fund organized and offered by a banking entity? If not, what alternative approach would be more effective and why? Should the agencies provide additional guidance on what “other services” should be included for purposes of satisfying § __.11(g)? Why or why not?

Question [•]. Are the disclosure requirements related to organizing and offering a covered fund appropriate? If not, what alternative disclosure requirement(s) should the proposed rule include? Should the Agencies consider adoption of a model disclosure form related to this requirement? Does the timing of the proposed disclosure requirement adequately address disclosure to secondary market purchasers?

3. Section __.12: Permitted investment in a covered fund.

Section __.12 of the proposed rule describes the limited circumstances under which a banking entity may acquire or retain, as an investment, an ownership interest in a covered fund that the banking entity or one of its subsidiaries or affiliates organizes and offers. This section implements section 13(d)(4) of the BHC Act and related provisions, and describes the statutory limits on both (i) the amount and value of an investment by a banking entity in a covered fund, and (ii) the aggregate value of all investments in all covered funds made by the banking entity.

As described below, a banking entity that makes or retains an investment in a covered fund under § __.12 of the proposed rule is generally subject to three principal limitations related to such investment. First, the banking entity’s investment in a covered fund may not represent more than 3 percent of the total outstanding ownership interests of such fund (after the expiration of any seeding period provided under the rule). Second, the banking entity’s investment in a covered fund may not result in more than 3 percent of the losses of the covered fund being allocable to the banking entity’s investment. Third, a banking entity may invest no more than 3 percent of its tier 1 capital in covered funds.²⁵⁹

1. Authority and limitations on permitted investments.

Section 13(d)(4) of the BHC Act permits a banking entity to acquire and retain an ownership interest in a covered fund that the banking entity organizes and offers pursuant to section 13(d)(1)(G), for the purposes of (i) establishing the covered fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or (ii) making a de minimis investment in the covered fund in compliance with applicable requirements.²⁶⁰ Section __.12 of the proposed rule implements this authority and related limitations.

²⁵⁹ See, e.g., proposed rule §§ __.12(b)(2), (c).

²⁶⁰ See 12 U.S.C. 1851(d)(4).

Consistent with this statutory provision, the proposed rule requires a banking entity to (i) actively seek unaffiliated investors to ensure that the banking entity's investment conforms with the limits of § __.12, and (ii) reduce through redemption, sale, dilution, or other methods the aggregate amount and value of all ownership interests of the banking entity in a single fund held under § __.12 to an amount that does not exceed 3 percent of the total outstanding ownership interests of the fund not later than 1 year after the date of establishment of the fund (or such longer period as may be provided by the Board pursuant to § __.12(e) of the proposed rule) (the "per-fund limitation"). Additionally, § __.12 of the proposed rule implements the statutory requirement that the aggregate value of all ownership interests of the banking entity in all covered funds held as an investment not exceed 3 percent of the tier 1 capital of the banking entity (the "aggregate funds limitation").²⁶¹

2. Permitted investment in a single covered fund.

Section __.12(b) of the proposed rule describes the limitations and restrictions on a banking entity's ability to make or retain an investment in a single covered fund. This section implements the requirements of section 13(d)(4) of the BHC Act.²⁶²

Section __.12 of the proposed rule describes the manner in which the limitations on the amount and value of ownership interests in a covered fund must be calculated, in recognition of the fact that a covered fund may have multiple classes of ownership interests which possess different characteristics or values that impact a person's ownership in that fund. A banking entity must apply the limits to both the total value and amount of its investment in a covered fund. For purposes of applying these limits, the banking entity must calculate (without regard to committed funds not yet called for investment): (i) the value of all investments or capital contributions made with respect to any ownership interest by the banking entity in a covered fund, divided by the value of all investments or capital contributions made by all persons in that covered fund, and (ii) the total number of ownership interests held as an investment by the banking entity in a covered fund divided by the total number of ownership interests held by all persons in that covered fund.²⁶³ Therefore, under the proposed rule, such calculation would include as the numerator the amount or value of a banking entity's investment in a covered fund, and as the denominator the amount or value (matched to the unit of measurement in the numerator) of all classes of ownership interests held by all persons in that covered fund. As noted above, the banking entity's investment in a covered fund also may not result in more than 3 percent of the losses of the covered fund being allocable to the banking entity's investment.²⁶⁴

²⁶¹ See proposed rule at § __.12(a)(2)(ii). The process and manner in which a banking entity's 3 percent tier 1 capital limit is determined for purposes of the proposed rule is discussed in detail below in Part III.C.3 of this Supplementary Information.

²⁶² See 12 U.S.C. 1851(d)(4)(B).

²⁶³ See proposed rule § __.12(b)(2).

²⁶⁴ Under the proposed rule, a banking entity's investment in a covered fund may not result in more than 3 percent of the losses of the covered fund being allocable to the banking entity's investment since the banking entity's permitted investment in a covered fund may be no more than 3 percent of the value and amount of such fund's total ownership interests, and the banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund. See 12 U.S.C. 1851(d)(1)(G)(v); proposed rule § __.11(e).

In order to ensure that a banking entity calculates its investment in a covered fund accurately and does not evade the per-fund investment limitation, the proposed rule requires that the banking entity must calculate its investment in the same manner and according to the same standards utilized by the covered fund for determining the aggregate value of the fund's assets and ownership interests in the covered fund.²⁶⁵

Under the proposed rule, the amount and value of a banking entity's investment in any single covered fund is (i) the total amount or value held by the banking entity directly and through any entity that is controlled, directly or indirectly, by the banking entity,²⁶⁶ plus (ii) the pro rata amount or value of any covered fund held by any entity (other than certain operating entities noted below) that is not controlled, directly or indirectly, by the banking entity but in which the banking entity owns, controls, or holds with the power to vote more than 5 percent of the voting shares.²⁶⁷

Additionally, the proposed rule provides that, to the extent that a banking entity is contractually obligated to directly invest in, or is found to be acting in concert through knowing participation in a joint activity or parallel action toward a common goal of investing in, one or more investments with a covered fund that is organized and offered by the banking entity (whether or not pursuant to an express agreement), such investment shall be included in the calculation of a banking entity's per-fund limitation.²⁶⁸ In this way, the proposed rule prevents a banking entity from evading the limitations under § __.12 of the proposed rule through committed co-investments.

Section __.12(b)(3) of the proposed rule provides that the amount and value of a banking entity's investment in a covered fund may at no time exceed the 3 percent limits contained in § __.12(b) of the proposed rule after the conclusion of any conformance period, if applicable.²⁶⁹ In cases where a fund calculates its value or stands ready to issue or redeem interests frequently (e.g., daily), a banking entity must calculate its per-fund limitation no less frequently than the fund performs such calculation or issues or redeems interests. In recognition of the fact that not every covered fund may calculate or determine its valuation daily (for instance, if it does not allow redemptions except infrequently or invests principally in illiquid assets for which no market price is readily available), the proposed rule would not require a daily calculation of value for such fund (unless a daily calculation is determined by the fund).²⁷⁰ In such cases, the calculation of the amount and value of a banking entity's per-fund limitation must be made no

²⁶⁵ See proposed rule § __.12(b)(4).

²⁶⁶ See proposed rule § __.12(b)(1)(A).

²⁶⁷ See proposed rule § __.12(b)(1)(B). As noted above, whether or not an investment is controlled or noncontrolled will be determined consistent with the BHC Act, as implemented by the Board. See 12 U.S.C. 1841(a)(2); 12 CFR 225.2(e).

²⁶⁸ See proposed rule § __.12(b)(2)(B).

²⁶⁹ See proposed rule § __.12(b)(3).

²⁷⁰ With respect to an issuer of asset-backed securities, depending on the transaction structure, such calculation may need to be made each time a payment is made to any holder of the issuer's asset-backed securities.

less frequently than at the end of every quarter.²⁷¹ Additionally, since a banking entity must organize and offer any covered fund in which it invests, the Agencies expect that such banking entity would closely and regularly monitor not only the value of such fund's interests, but also any changes in the fund's investors' relative ownership percentages.²⁷²

3. Aggregate permitted investments in all covered funds and calculation of a banking entity's tier 1 capital.

In addition to a limit on investments in a single covered fund, section 13(d)(4) of the BHC Act requires the banking entity to comply with the aggregate funds limitation on investments in all covered funds.²⁷³ As required under section 13(d)(4)(B)(ii)(II) of the BHC Act, the proposed rule provides that the aggregate of a banking entity's ownership interests in all covered funds that are held under § __.12 of the proposed rule may not exceed 3 percent of the tier 1 capital of a banking entity.²⁷⁴ In order to maintain equality in application of the aggregate funds limitation, the proposed rule provides that, for purposes of determining compliance with § __.12 of the proposed rule, the aggregate of all of a banking entity's investments in all covered funds under § __.12 of the proposed rule must be valued pursuant to applicable accounting standards.²⁷⁵ This value calculation is separate and in addition to the required calculation of the value of a banking entity's investment in a covered fund as part of determining compliance with the per-fund limitation.

Tier 1 capital is a banking law concept that, in the United States, is calculated and reported by certain depository institutions and bank holding companies in order to determine their compliance with regulatory capital standards. Accordingly, the proposed rule clarifies that for purposes of the aggregate funds limitation in § __.12, a banking entity that is a bank, a bank holding company, a company that controls an insured depository institution that reports tier 1 capital, or uninsured trust company that reports tier 1 capital (each a "reporting banking entity") must apply the reporting 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.²⁷⁶

²⁷¹ The Agencies note that while calculation of a banking entity's ownership interest in a covered fund must be determined no less frequently than at the end of every quarter, it is possible that no change in a banking entity's ownership interest (e.g., no redemptions or other changes in investor composition) may occur during every quarter.

²⁷² For instance, where a banking entity acts as sponsor to a covered fund, in connection with the organizing and offering of that fund it may include a requirement (such as a "tag-along" redemption right) in the fund's organizational documents in order to assist the banking entity in complying with the per-fund investment limitation.

²⁷³ As noted in the discussion regarding the per-fund limitation, the proposed rule provides that, for purposes of determining compliance with § __.12, the banking entity's permitted investment in a covered fund shall be calculated in the same manner and according to the same standards utilized by the covered fund for determining the aggregate value of the fund's assets and ownership interests. However, the value of a banking entity's aggregate permitted investments in all covered funds shall be determined in accordance with applicable accounting standards. See proposed rule § __.12(c)(1).

²⁷⁴ See 12 U.S.C. 1851(d)(4)(B)(ii)(II); proposed rule § __.12(a)(2)(ii).

²⁷⁵ See proposed rule § __.12(c)(1).

²⁷⁶ See proposed rule § __.12(c)(1)(A).

However, not all entities subject to section 13 of the BHC Act calculate and report tier 1 capital. In order to provide a measure of equality related to the aggregate funds limitation contained in section 13(d)(4)(B)(ii)(II) of the BHC Act and § __.12(c) of the proposed rule, the proposed rule clarifies how the aggregate funds limitation shall be calculated for entities that are not required to calculate and report tier 1 capital in order to determine compliance with regulatory capital standards. Under the proposed rule, with respect to any banking entity that is not affiliated with a reporting banking entity and not itself required to report capital in accordance with the risk-based capital rules of a Federal banking agency, the banking entity's tier 1 capital for purposes of the aggregate funds limitation shall be the total amount of shareholders' equity of the top-tier entity within such organization as of the last day of the most recent calendar quarter that has ended, as determined under applicable accounting standards.²⁷⁷ For a banking entity that is not itself required to report tier 1 capital but is a subsidiary of a reporting banking entity that is a depository institution (e.g., a subsidiary of a national bank), the aggregate funds limitation shall be the amount of tier 1 capital reported by such depository institution.²⁷⁸ For a banking entity that is not itself required to report tier 1 capital but is a subsidiary of a reporting banking entity that is not a depository institution (e.g., a nonbank subsidiary of a bank holding company), the aggregate funds limitation shall be the amount of tier 1 capital reported by the top-tier affiliate of such banking entity that holds and reports tier 1 capital.²⁷⁹ Thus, for purposes of calculating the aggregate funds limitation under § __.12(c)(2) of the proposed rule, the tier 1 capital for the different types of banking entities would be as follows:

<u>Type of banking entity</u>	<u>Tier 1 capital for purposes of § __.12</u>
Depository institution that is a reporting banking entity (or a subsidiary thereof)	Tier 1 capital of the depository institution as of the last day of the most recent calendar quarter that has ended, as reported to the relevant Federal banking agency
Bank holding company or a subsidiary thereof (other than a reporting banking entity)	Tier 1 capital of the bank holding company as of the last day of the most recent calendar quarter that has ended, as reported to the Board
Company that controls an insured depository institution and that is a reporting banking entity (or a subsidiary thereof other than a reporting banking entity)	Tier 1 capital of the top tier entity within such organization as of the last day of the most recent calendar quarter that has ended, as reported to the Board
Other banking entity (including an industrial loan company holding company, thrift holding company, or a subsidiary thereof)	Shareholders' equity of the top-tier entity within such organization as of the last day of the most recent calendar quarter that has

²⁷⁷ See proposed rule § __.12(c)(2)(ii)(B)(2).

²⁷⁸ See proposed rule § __.12(c)(2)(ii)(A).

²⁷⁹ See proposed rule § __.12(c)(1)(B).

	ended, under applicable accounting standards
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Additionally, in the case of a depository institution that is itself a reporting banking entity and is also a subsidiary or affiliate of a reporting banking entity, the aggregate of all investments in all covered funds held by the depository institution (including investments by its subsidiaries) may not exceed 3 percent of either the tier 1 capital of the depository institution or of the top-tier reporting banking entity that controls such depository institution.²⁸⁰

4. Deduction of an investment in a covered fund from tier 1 capital.

Section 12(d) of the proposed rule also implements the provision contained in section 13(d)(4)(b)(iii) of the BHC Act regarding the deduction of a banking entity's aggregate investment in a covered fund held under section 13(d)(4) of that Act from the assets and tangible equity of the banking entity. The statute also provides that the amount of the deduction must increase commensurate with the leverage of the underlying fund.²⁸¹

Section __.12(d) of the proposal requires a banking entity to deduct the aggregate value of its investments in covered funds from tier 1 capital. Since § __.12 of the proposed rule implements the authorities contained in section 13(d)(4) of the BHC Act related to an investment in a fund organized and offered by the banking entity (or an affiliate or subsidiary thereof), the deduction contained in § __.12(d) applies only to those ownership interests held as an investment by a banking entity pursuant to § __.12 of the proposed rule.²⁸² For instance, a banking entity that acquires or retains an ownership interest in a covered fund as a permitted risk-mitigating hedge under § __.13(b) of the proposed rule, or that acquires or retains an ownership interest in the course of collecting a debt previously contracted in good faith, would not be required to deduct the value of such ownership interest from its tier 1 capital.²⁸³ The deduction required under § __.12(d) of the proposed rule must be calculated consistent with other like deductions under the applicable risk-based capital rules.²⁸⁴

5. Extension of time to divest an ownership interest in a single covered fund.

²⁸⁰ If the aggregate value of all investments in all covered funds attributable to such a depository institution is less than 3 percent of its tier 1 capital, then that amount of capital which is greater than the amount supporting the depository institution's investments (or those held by its subsidiaries) in a covered fund, but less than 3 percent of the depository institution's tier 1 capital, may be used to support an investment in a covered fund by an affiliated banking entity that is not itself a depository institution that holds and reports tier 1 capital or controlled, directly or indirectly, by such a depository institution.

²⁸¹ See 12 U.S.C. 1851(d)(4)(B)(iii).

²⁸² See proposed rule § __.12(d).

²⁸³ The Agencies note that since this deduction from capital implements Section 13(d)(4)(B)(iii) of the BHC Act, it is being included in this proposed rule which deals with Section 13 of the BHC Act. However, the Agencies may relocate this deduction as part of any later revised capital rules if, in the future, it is determined that inclusion in such rules is more appropriate.

²⁸⁴ See 12 CFR part 208, Appendices A, E, and F (for a state member bank); 12 CFR part 225, Appendices A, E, and G (for a bank holding company); 12 CFR part 3, Appendices A, B, and C (for a national bank); 12 CFR part 325, Appendices A, C, and D (for a state nonmember bank); and 12 CFR part 167, Appendix C (for a federal thrift)..

Section 13(d)(4)(C) of the BHC Act permits the Board, upon application by a banking entity, to extend for up to 2 additional years the period of time within which a banking entity must reduce its attributable ownership interests in a covered fund to no more than 3 percent of such fund's total ownership interests.²⁸⁵ The statute provides the possibility of an extension only with respect to the per-fund limitation, and not to the aggregate funds limitation.²⁸⁶ Section __.12(e) of the proposed rule implements this provision of the statute. In order to grant any extension, the Board must determine that the extension would be consistent with safety and soundness and would not be detrimental to the public interest.²⁸⁷

Section __.12(e) of the proposed rule requires any banking entity that seeks an extension of this conformance period to submit a written request to the Board. Under the proposal, any such request must: (i) be submitted in writing to the Board at least 90 days prior to the expiration of the applicable time period; (ii) provide the reasons why the banking entity believes the extension should be granted; and (iii) provide a detailed explanation of the banking entity's plan for reducing or conforming its investment(s).

In addition, the proposed rule provides that any extension request by a banking entity must address each of the following matters (to the extent they are relevant): (i) whether the investment would – (A) involve or result in material conflicts of interest between the banking entity and its clients, customers or counterparties; (B) result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies; (C) pose a threat to the safety and soundness of the banking entity; or (D) pose a threat to the financial stability of the United States; (ii) market conditions; (iii) the contractual terms governing the banking entity's interest in the covered fund; (iv) the date on which the covered fund is expected to have attracted sufficient investments from investors unaffiliated with the banking entity to enable the banking entity to comply with the limitations in section 12(a)(2)(i)(B) of the proposed rule; (v) the total exposure of the banking entity to the investment and the risks that disposing of, or maintaining, the investment in the covered fund may pose to the banking entity or the financial stability of the United States; (vi) the cost to the banking entity of divesting or disposing of the investment within the applicable period; (vii) whether the divestiture or conformance of the investment would involve or result in a material conflict of interest between the banking entity and unaffiliated clients, customers or counterparties to which it owes a duty; (viii) the banking entity's prior efforts to divest or sell interests in the covered fund, including activities related to the marketing of interests in such covered fund; and (ix) any other factor that the Board believes appropriate.²⁸⁸ Under the proposed rule, the Board would consider requests

²⁸⁵ 12 U.S.C. 1851(d)(4)(C).

²⁸⁶ See id.

²⁸⁷ As noted in Part III.C.2.a.ii of this Supplementary Information, the Agencies recognize the potential for evasion of the restrictions contained in section 13 of the BHC Act through organizing and offering a covered fund pursuant to the authority contained in § __.11 of the proposed rule. Therefore, in addition to taking action against a banking entity that does not actively seek unaffiliated investors to reduce or dilute the investment of the banking entity as provided under § __.12(a)(2) of the proposed rule, the Agencies expect that if a banking entity is habitually or routinely seeking an extension of the one-year period provided under § __.12(a)(2)(i)(B), this could be evidence of seeking to evade the restrictions contained in the proposed rule and, as appropriate, the Agencies may take action against such banking entity.

²⁸⁸ See proposed rule § __.12(e)(1)(ii).

for an extension in light of all relevant facts and circumstances, including the factors described above.

Section __.12(e) of the proposed rule also would allow the Board to impose conditions on any extension granted under the proposed rule if the Board determines conditions are necessary or appropriate to protect the safety and soundness of banking entities or the financial stability of the United States, address material conflicts of interest or other unsound practices, or otherwise further the purposes of section 13 of the BHC Act and the proposed rule.²⁸⁹ In cases where the banking entity is primarily supervised by another Agency, the Board would consult with such Agency both in connection with its review of the application and, if applicable, prior to imposing conditions in connection with the approval of any request by the banking entity for an extension of the conformance period under the proposed rule.²⁹⁰

Request for comment

The Agencies request comment on the proposed rule's approach to implementing the exemption which allows a banking entity to make or retain a permitted investment in a covered fund that it organizes and offers. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule's approach to implementing the exemption that allows a banking entity to make or retain a permitted investment in a covered fund effective? If not, what alternative approach would be more effective and why?

Question [•]. Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

Question [•]. Should the proposed rule specify at what point a covered fund will be considered to have been "established" for purposes of commencing the period in which a banking entity may own more than 3 percent of the total outstanding ownership interests in such fund? If so, why and how?

Question [•]. Does the proposed rule effectively implement the requirement that a banking entity comply with the limitations on an investment in a single covered fund? If not, what alternative approach would be more effective and why?

Question [•]. Does the proposed rule effectively implement the requirement that a banking entity comply with the limitations on the aggregate of all investments in all covered funds? If not, what alternative approach would be more effective and why?

²⁸⁹ Nothing in section 13 of the BHC Act or the proposed rule limits or otherwise affects the authority that the Board, the other Federal banking agencies, the SEC, or the CFTC may have under other provisions of law. In the case of the Board, these authorities include, but are not limited to, section 8 of the Federal Deposit Insurance Act and section 8 of the BHC Act. See 12 U.S.C. 1818, 1847.

²⁹⁰ See proposed rule §§ __.12(e)(iii) and (iv).

Question [•]. Is the proposed rule's approach to calculating a banking entity's investment in a covered fund effective? Should the per-fund calculation be based on committed capital, rather than invested capital? Why or why not? Is the timing of the calculation of a banking entity's ownership interest in a single covered fund appropriate? If not, why not, and what alternative approach would be more effective and why? For example, should the per-fund calculation be required on a less-frequent basis (e.g., monthly) for funds that compute their value and allow purchases and redemptions on a daily basis (e.g., liquidity funds)? Why or why not?

Question [•]. Is the proposed rule's approach to parallel investments effective? Why or why not? Should this provision require a contractual obligation and/or knowing participation? Why or why not? How else could the proposed rule define parallel investments? What characteristics would more closely achieve the scope and intended purposes of section 13 of the BHC Act?

Question [•]. Is the proposed rule's treatment of investments in a covered fund by employees and directors of a banking entity effective? If not, what alternative approach would be more effective and why?

Question [•]. Is the proposed rule's approach to differentiating between controlled and noncontrolled investments in a covered fund unduly complex or burdensome? If so, what alternative approach, if any, would be more effective and why?

Question [•]. Is the proposed rule's approach to valuing an investment in a covered fund according to the same standards utilized by the covered fund for determining the aggregate value of its assets and ownership interests effective? If not, what alternative valuation approach would be more effective and why? Should the rule specify one methodology for valuing an investment in a covered fund?

Question [•]. Is the proposed rule's approach regarding when to require the calculation of a banking entity's aggregate investments in all covered funds effective? What is the potential impact of calculating a banking entity's aggregate investment limit under the proposed rule on a quarterly basis as opposed to solely at the time an investment in a covered fund is made? Would calculation of the aggregate investment limit solely at the time an investment in a covered fund is made be consistent with the language and purpose of the statute? Does the proposed rule provide sufficient guidance for an issuer of asset-backed securities about how and when to make such calculation? Why or why not?

Question [•]. Is the proposed rule's approach to determining and calculating a banking entity's relevant tier 1 capital limit effective? If not, what alternative approach would be more effective and why? With respect to applying the aggregate funds limitation to a banking entity that is not affiliated with an entity that is required to hold and report tier 1 capital, is total shareholder equity on a consolidated basis as of the last day of the most recent calendar quarter that has ended an effective proxy for tier 1 capital? If not, what alternative approach would be more effective and why?

Question [•]. Should the proposed rule be modified to permit a banking entity to bring its investments in covered funds into compliance with the proposed rule within a reasonable period or time if, for example, the banking entity's aggregate permitted investments in covered funds exceeds 3 percent of its tier 1 capital for reasons unrelated to additional investments (e.g., a banking entity's tier 1 capital decreases)? Why or why not?

Question [•]. Does the proposed rule effectively and appropriately implement the deduction from capital for an investment in a covered fund contained in section 13(d)(4)(B)(iii) of the BHC Act? If not, what alternative approach would be more effective or appropriate, given the statutory language of the BHC Act and overall structure of section 13(d)(4), and why? What effect, if any, should the agencies give to the cross-reference in section 13(d)(4) to section 13(d)(3) of the BHC Act, which provides agencies with discretion to require additional capital, if appropriate, to protect the safety and soundness of banking entities engaged in activities permitted under section 13 of the BHC Act? How, if at all, should a banking entity's deduction of its investment in a covered fund be increased commensurate with the leverage of the covered fund? Should the amount of the deduction be proportionate to the leverage of the covered fund? For example, instead of a dollar-for-dollar deduction, should the deduction be set equal to the banking entity's investment in the covered fund times the difference between 1 and the covered fund's equity-to-assets ratio?

Question [•]. Does the proposed rule effectively implement the Board's statutory authority to grant an extension of the period of time a banking entity may retain in excess of 3 percent of the ownership interests in a single covered fund? Are the enumerated factors that the Board may consider in connection with reviewing such an extension appropriate (including factors related to the effect of an extension of the covered fund), and if not, why not? Are there additional factors that the Board should consider in reviewing such a request? Are there specific additional conditions or limitations that the Board should, by rule, impose in connection with granting such an extension? If so, what conditions or limitations would be more effective?

Question [•]. Given that the statute does not provide for an extension of time for a banking entity to comply with the aggregate funds limitation, within what period of time should a banking entity be required to bring its investments into conformance with the aggregate funds limit? Should the proposed rule expressly contain a grace period for complying with these limits? Why or why not? If yes, what grace period would be most effective and why?

Question [•]. Does the proposed rule effectively implement the prohibition on a banking entity guaranteeing or insuring the obligations or performance of certain covered funds? If not, what alternative approach would be more effective and why?

Question [•]. In the context of securitization transactions, control and ownership are often completely separated. Is additional guidance necessary with respect to how control should be determined with respect to issuers of asset-backed securities for purposes of determining the calculation of the per-fund and aggregate ownership limitations?

Question [•]. In many securitization transactions, the voting rights of investors are extremely limited and management may be contractually delegated to a third party (because issuers of asset-backed securities rarely have a board with any authority or any employees). The

servicer or manager has the “ability to control the decision-making and operational functions of the fund.” When calculating the per-fund and aggregate ownership limitations, to whom should the proposed rule allocate “control” in this type of situation? Which participants in a securitization transaction would need to include the activities of an issuer of asset-backed securities in their calculations of per-fund and aggregate ownership, and what is the potential impact of such inclusion?

Question [•]. For purposes of calculating the per-fund and aggregate ownership limitations, how should the proposed rule address those instances in which equity is issued, but the equity holder does not receive economic benefits or have any control rights? For instance, in order to enhance or achieve bankruptcy remoteness, a single purpose trust without an owner (i.e., an orphan trust) may hold all of the equity interests in a securitization vehicle. Such interests often do not have any meaningful economic or control rights.

4. Section __.13: Other permitted covered fund activities and investments.

Section 13 of the proposed rule implements the statutory exemptions described in sections 13(d)(1)(C), (E), and (I) of the BHC Act that permit a banking entity: (i) to acquire an ownership interest in, or act as sponsor to, one or more SBICs, a public welfare investment, or a certain qualified rehabilitation expenditure;²⁹¹ (ii) to acquire or retain an ownership interest in a covered fund as a risk-mitigating hedging position; and (iii) in the case of a non-U.S. banking entity, to acquire or retain an ownership interest in or sponsor a foreign covered fund. Additionally, § __.13 of the proposed rule implements in part the rule of construction related to the sale and securitization of loans contained in section 13(g)(2) of the BHC Act. Similar to § __.6 of the proposed rule (which implements certain permitted proprietary trading activities), § __.13 contains only the statutory exemptions contained in section 13(d)(1) of the BHC Act that the Agencies have determined apply, either by plain language or by implication, to investments in or relationships with a covered fund.²⁹²

a. Permitted investments in SBICs and related funds.

Section __.13(a) of the proposed rule implements sections 13(d)(1)(E) and (J) of the BHC Act²⁹³ and permits a banking entity to acquire or retain any ownership interest in, or act as

²⁹¹ Section __.13(a) of the proposed rule also implements a proposed determination by the Agencies under section 13(d)(1)(J) of the BHC Act that a banking entity may not only invest in such entities as provided under section 13(d)(1)(E) of the BHC Act, but also may sponsor an entity described in that paragraph and that such activity, since it generally would facilitate investment in small businesses and support the public welfare, would promote and protect the safety and soundness of banking entities and the financial stability of the United States.

²⁹² In particular, § __.13 of the proposed rule does not include: (i) the exemption in section 13(d)(1)(A) of the BHC Act for trading in certain permitted government obligations; (ii) the exemption in section 13(d)(1)(H) of the BHC Act for certain foreign proprietary trading activities; and (iii) the exemption contained in section 13(d)(1)(B) of the BHC Act related to underwriting and market-making related activities. Each of these exemptions appear relevant only to covered trading activities and not to covered fund activities.

²⁹³ Section 13(d)(1)(E) of the BHC Act permits a banking entity to make investments in one or more SBICs, investments designed primarily to promote the public welfare, investments of the type permitted under 12 U.S.C. 24(eleventh), and investments that are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure. See 12 U.S.C. 1851(d)(1)(E).

sponsor to: (i) one or more SBICs, as defined in section 102 of the Small Business Investment Act of 1958 (12 U.S.C. § 662); (ii) an investment that is designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. § 24), including the welfare of low- and moderate-income communities or families (such as providing housing, services, or jobs); and (iii) an investment that is a qualified rehabilitation expenditure with respect to a qualified rehabilitation building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program.²⁹⁴ Since section 13(d)(1)(E) of the BHC Act does not limit a banking entity's investment to a limited partnership or other non-controlling investment, § __.13(a) of the proposed rule would permit a banking entity to be a shareholder, general partner, managing member, or trustee of an SBIC without regard to whether the interest is a controlling or noncontrolling interest.²⁹⁵

In addition to the acquisition or retention of an ownership interest, permitting a banking entity to act as sponsor to these types of public interest investments will provide valuable expertise and services to these types of entities, as well as help enable banking entities to provide valuable funding and assistance to small business and low- and moderate-income communities. Therefore, the Agencies believe this exemption would be consistent with the safe and sound operation of banking entities, and would also promote the financial stability of the United States.

The Agencies request comment on the proposed rule's approach to implementing the exemption for permitted investments in and relationships with SBICs and certain related funds. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule's approach to implementing the SBIC, public welfare and qualified rehabilitation investment exemption for acquiring or retaining an ownership interest in a covered fund effective? If not, what alternative approach would be more effective?

Question [•]. Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

Question [•]. Should the proposed rule permit a banking entity to sponsor an SBIC and other identified public interest investments? Why or why not? Does the Agencies' determination under section 13(d)(1)(J) of the BHC Act regarding sponsoring of an SBIC, public welfare or qualified rehabilitation investment effectively promote and protect the safety and soundness of banking entities and the financial stability of the United States? If not, why not?

Question [•]. What would the effect of the proposed rule be on a banking entity's ability to sponsor and syndicate funds supported by public welfare investments or low income housing tax credits which are utilized to assist banks and other insured depository institutions with meeting their Community Reinvestment Act ("CRA") obligations?

²⁹⁴ See proposed rule § __.13(a).

²⁹⁵ Pursuant to the exemption contained in § __.13(a) of the proposed rule, a banking entity may acquire an ownership interest in, or act as sponsor to, a low income housing credit fund, if such fund qualifies as an SBIC, public welfare investment or qualified rehabilitation expenditure.

Question [•]. Does the proposed rule unduly constrain a banking entity's ability to meet the convenience and needs of the community through CRA or other public welfare investments or services? If so, why and how could the proposed rule be revised to address this concern?

b. Permitted risk-mitigating hedging activities.

Section __.13(b) of the proposed rule permits a banking entity to acquire and retain an ownership interest in a covered fund if the transaction is made in connection with, and related to, certain individual or aggregated positions, contracts, or other holdings of the banking entity and is designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings. This section of the proposed rule implements, in relevant part, section 13(d)(1)(C) of the BHC Act, which provides an exemption from the prohibition on acquiring or retaining an ownership interest in a covered fund for certain risk-mitigating hedging activities.²⁹⁶

Interests by a banking entity in a covered fund may not typically be used as hedges for specific positions, contracts, or other holdings of a banking entity. However, two situations where a banking entity may potentially acquire or retain an ownership interest in a covered fund as a hedge are (i) when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund (similar to acting as a "riskless principal"),²⁹⁷ and (ii) to cover a compensation arrangement with an employee of the banking entity that directly provides investment advisory or other services to that fund. Section __.13(b) of the proposed rule provides an exemption for banking entity to acquire or retain an ownership interest in a covered fund in these limited situations.²⁹⁸

i. Approach for hedges using an ownership interest in a covered fund.

As noted above in the discussion of § __.5 of the proposed rule, risk-mitigating hedging activities present certain implementation challenges because of the potential that prohibited activities or investments could be conducted in the context of, or mischaracterized as, hedging transactions. In light of these complexities, the Agencies have proposed a multi-faceted approach to implementation, which is discussed in detail above in reference to § __.5 of the proposed rule.²⁹⁹ As with the hedging exemption provided under § __.5, this multi-faceted approach is intended to clearly articulate the Agencies' expectations regarding the scope of permitted hedging activities under § __.13(b) in a manner that limits potential abuse of the hedging exemption while not unduly constraining the important risk management function that is served by a banking entity's hedging activities. However, because of the possibility that using an ownership interest in a covered fund as a hedging instrument may mask an intent to evade the

²⁹⁶ See 12 U.S.C. 1851(d)(1)(C).

²⁹⁷ In order to prevent evasion of the general limitation that a banking entity may not acquire or retain more than 3 percent of the ownership interests in any single covered fund that such banking entity organizes and offers, the proposed rule limits a banking entity's ability to acquire or retain an ownership interest in a covered fund as a permitted risk-mitigating hedge to those situations where the customer of the banking entity is not itself a banking entity. See proposed rule § __.13(b)(1)(i)(A).

²⁹⁸ See proposed rule § __.13(b).

²⁹⁹ See Supplementary Information, Part III.B.3.

limitations on the amount and value of ownership interests in a covered fund or funds under § __.12, the proposed rule contains several additional requirements related to a banking entity's ability to use an ownership interest in a covered fund as a hedging instrument.

ii. Required criteria for permitted risk-mitigating hedging activities involving a covered fund.

Section __.13(b) of the proposed rule describes the criteria that a banking entity must meet in order to rely on the hedging exemption with respect to ownership interests of a covered fund. The majority of these requirements are substantially similar to those discussed in detail above in connection with the risk-mitigating hedging exemption contained in § __.5 of the proposed rule, and include the requirements that: (i) the hedge is made in connection with and related to individual or aggregated obligations or liabilities of the banking entity that are: (A) taken by the banking entity when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund, or (B) directly connected to a compensation arrangement with an employee that directly provides investment advisory or other services to the covered fund; (ii) the banking entity has established the internal compliance program required by subpart D designed to ensure the banking entity's compliance with the requirements of this paragraph, including reasonably designed written policies and procedures regarding the instruments, techniques and strategies that may be used for hedging, internal controls and monitoring procedures, and independent testing; (iii) the transaction is designed to reduce the specific risks to the banking entity in connection with and related to such obligations or liabilities; (iv) the acquisition or retention of an ownership interest in a covered fund: (A) is made in accordance with the written policies, procedures and internal controls established by the banking entity pursuant to subpart D; (B) hedges or otherwise mitigates an exposure to a covered fund through a substantially similar offsetting exposure to the same covered fund and in the same amount of ownership interest in that covered fund that arises out of a transaction conducted solely to accommodate a specific customer request with respect to, or directly connected to its compensation arrangement with an employee that directly provides investment advisory or other services to, that covered fund; (C) does not give rise, at the inception of the hedge, to significant exposures that were not already present in individual or aggregated positions, contracts, or other holdings of a banking entity and are not hedged contemporaneously; and (D) is subject to continuing review, monitoring and management by the banking entity that: (1) is consistent with its written hedging policies and procedures; (2) maintains a substantially similar offsetting exposure to the same amount and type of ownership interest, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate; and (3) mitigates any significant exposure arising out of the hedge after inception; and (v) the compensation arrangements of persons performing the risk-mitigating hedging activities are designed not to reward proprietary risk-taking.³⁰⁰

These requirements, while substantially similar to those contained in § __.5 above, are different in several material aspects. First, § __.13(b)(1)(i) of the proposed rule provides that any banking entity relying on this exemption may only hedge or otherwise mitigate one or more specific risks arising in connection with and related to the two situations enumerated in that

³⁰⁰ See proposed rule § __.13(b).

section. These are risks taken by the banking entity when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund, or directly connected to its compensation arrangement with an employee that directly provides investment advisory or other services to the covered fund.³⁰¹ Second, § __.13(b)(2)(ii)(B) of the proposed rule requires that the acquisition or retention of an ownership interest in a covered fund hedge or otherwise mitigate a substantially similar offsetting exposure to the same covered fund and in the same amount of ownership interest in that covered fund, which requires greater equivalency between the reference asset and hedging instrument than the correlation required under § __.5. Third, § __.13(b)(3) of the proposed rule imposes a documentation requirement on all types of hedging transactions where the banking entity uses ownership interests in a covered fund as the hedging instrument. This requirement is broader than that contained in § __.5 and is reflective of the limited scope of positions or exposures for which a banking entity may acquire or retain an ownership interest in a covered fund as a hedge. Specifically, for any transaction that a banking entity acquires or retains an ownership interest in a covered fund in reliance of the hedging exemption, the banking entity must document the risk-mitigating purposes of the transaction and identify the risks of the individual or aggregated positions, contracts, or other holding of the banking entity that the transaction is designed to reduce. Such documentation must be established at the time the hedging transaction is effected, not after the fact. This documentation requirement establishes a contemporaneous record that will assist the Agencies in assessing the actual reasons for which the position was established.

iv. Request for comment.

In addition to those questions raised in connection with the proposed implementation of the risk-mitigating hedging exemption under § __.5 of the proposed rule, the Agencies request comment on the proposed implementation of that same exemption with respect to covered fund activities. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule's approach to implementing the hedging exemption for acquiring or retaining an ownership interest in a covered fund effective? If not, what alternative approach would be more effective?

Question [•]. Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

Question [•]. What burden will the proposed approach to implementing the hedging exemption have on banking entities? How can any burden be minimized or eliminated in a manner consistent with the language and purpose of the statute?

Question [•]. Are the criteria included in § __.13(b)'s hedging exemption effective? Is the application of each criterion to potential transactions sufficiently clear? Should any of the criteria be changed or eliminated? Should other requirements be added?

³⁰¹ See proposed rule § __.13(b)(1)(i).

Question [•]. Is the requirement that an ownership interest in a covered fund may only be used as a hedge (i) by the banking entity when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund, or (ii) to cover compensation arrangements with an employee of the banking entity that directly provides investment advisory or other services to that fund effective? If not, what other requirements would be more effective?

Question [•]. Does the proposed rule sufficiently articulate the types of risks and positions that a banking entity typically would utilize an ownership interest in a covered fund to hedge? If not, how should the proposal be changed?

Question [•]. Is the requirement that that the hedging transaction involve a substantially similar offsetting exposure to the same covered fund and in the same amount of ownership interest to the risk or risks the transaction is intended to hedge or otherwise mitigate effective? If not, how should the requirement be changed? Should some other level of correlation be required? Should the proposal specify in greater detail how correlation should be measured? If not, how could it better do so?

Question [•]. Is the requirement that the transaction not give rise, at the inception of the hedge, to material risks that are not themselves hedged in a contemporaneous transaction effective? Is the proposed materiality qualifier appropriate and sufficiently clear? If not, what alternative would be effective and/or clearer?

Question [•]. Is the requirement that any transaction conducted in reliance on the hedging exemption be subject to continuing review, monitoring and management after the transaction is established effective? If not, what alternative would be more effective?

Question [•]. Is the proposed documentation requirement effective? If not, what alternative would be more effective? What burden would the proposed documentation requirement place on covered banking entities? How might such burden be reduced or eliminated in a manner consistent with the language and purpose of the statute?

c. Permitted covered fund activities and investments outside of the United States.

Section __.13(c) of the proposed rule, which implements section 13(d)(1)(I) of the BHC Act,³⁰² permits certain foreign banking entities to acquire or retain an ownership interest in, or to act as sponsor to, a covered fund so long as such activity occurs solely outside of the United States and the entity meets the requirements of sections 4(c)(9) and 4(c)(13) of the BHC Act. The purpose of this statutory exemption appears to be to limit the extraterritorial application of the statutory restrictions on covered fund activities to foreign firms that, in the course of

³⁰² Section 13(d)(1)(I) of the BHC Act permits a banking entity to acquire or retain an ownership interest in, or have certain relationships with, a covered fund notwithstanding the prohibition on proprietary trading and restrictions on investments in, and relationships with, a covered fund, if: (i) such activity or investment is conducted by a banking entity pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act; (ii) the activity occurs solely outside of the United States; (iii) no ownership interest in such fund is offered for sale or sold to a resident of the United States; and (iv) the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. See 12 U.S.C. 1851(d)(1)(I).

operating outside of the United States, engage outside the United States in activities permitted under relevant foreign law, while preserving national treatment and competitive equality among U.S. and foreign firms within the United States.³⁰³ Consistent with this purpose, the proposed rule defines both the type of foreign banking entities that are eligible for the exemption and the circumstances in which covered fund activities or investments by such an entity will be considered to have occurred solely outside of the United States (including clarifying when an ownership interest will be deemed to have been offered for sale or sold to a resident of the United States).

i. Foreign banking entities eligible for the exemption.

Section __.13(c)(1)(i) of the proposed rule incorporates the statutory requirement that the banking entity not be, directly or indirectly, controlled by a banking entity that is organized under the laws of the United States or of one or more States. Consistent with the statutory language, banking entities organized under the laws of the United States or of one or more States, or the subsidiaries or branches thereof (wherever organized or licensed), may not rely on the exemption. Similarly, the U.S. subsidiaries or U.S. branches of foreign banking entities would not qualify for the exemption.

Section __.13(c)(2) clarifies when a banking entity would be considered to have met the statutory requirement that the banking entity conduct the activity pursuant to paragraphs 4(c)(9) or 4(c)(13) of the BHC Act³⁰⁴ Section 4(c)(9) of the BHC Act generally provides that the restrictions on nonbanking activities contained in section 4(a) of that statute do not apply to the ownership of shares held or activities conducted by any company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States, if the Board by regulation or order determines that, under the circumstances and subject to the conditions set forth in the regulation or order, the exemption would not be substantially at variance with the purposes of this Act and would be in the public interest.³⁰⁵ The Board has, in part, implemented section 4(c)(9) through subpart B of the Board's Regulation K, which specifies a number of conditions and requirements that a foreign banking organization must meet in order to use such authority. Such conditions and requirements include, for example, a qualifying foreign banking organization test that requires the foreign banking organization to demonstrate that more than half of its worldwide business is banking and that more than half of its banking business is outside the United States.

The proposed rule makes clear that a banking entity will qualify for the foreign fund exemption if the entity is a foreign banking organization subject to subpart B of the Board's

³⁰³ See 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

³⁰⁴ Section __.13(c)(2) of the proposed rule only addresses when a transaction or activity will be considered to have been conducted pursuant to section 4(c)(9) of the BHC Act; although the statute also references section 4(c)(13) of the BHC Act, the Board has applied the authority contained in that section only to include certain foreign activities of U.S. banking organizations. The express language of section 13(d)(1)(I) of the BHC Act limits its availability to foreign banking entities that are not controlled by a banking entity organized under the laws of the United States or of one or more states. A foreign banking entity may not rely on the exemptive authority of section 4(c)(13) and, so, that section is not addressed in the proposed rule.

³⁰⁵ See 12 U.S.C. 1843(c)(9).

Regulation K and the transaction occurs solely outside the United States. Section 13 of the BHC Act also applies to foreign companies that are banking entities covered by Section 13 but are not currently subject either to the BHC Act generally or the Board's Regulation K, for example, because the foreign company controls a savings association or an FDIC-insured industrial loan company but not a bank or branch in the United States. Accordingly, the proposed rule clarifies when such a foreign banking entity would be considered to have conducted a transaction or activity "pursuant to section 4(c)(9)" for purposes of the exemption at § __.13(c) of the proposed rule.³⁰⁶ In particular, the proposed rule proposes that to qualify for the foreign banking entity exemption, such firms must meet at least two of three requirements that evaluate the extent to which the foreign entity's business is conducted outside the United States, as measured by assets, revenues, and income. This test largely mirrors the qualifying foreign banking organization test that is made applicable under section 4(c)(9) and § 211.23(a) of the Board's Regulation K, except that the relevant test under § __.13(c)(2)(ii) of the proposed rule does not require such a foreign entity to demonstrate that more than half of its business is banking conducted outside the United States.³⁰⁷

ii. Transactions and activities solely outside of the United States.

Section __.13(c) of the proposed rule also clarifies when a transaction or activity will be considered to have occurred solely outside of the United States for purposes of the exemption. In interpreting this aspect of the statutory language, the proposal focuses on the extent to which material elements of the transaction occur within, or are effected by personnel within, the United States. This aspect of the proposal reflects the apparent intent of the foreign funds exemption to avoid extraterritorial application of the restrictions on covered funds activities and investments outside the United States while preserving competitive parity within U.S. market. The proposed rule does not evaluate solely whether the risk of the transaction or activity, or management or decision-making with respect to such transaction or activity, rests outside the United States. Rather, the proposal also provides that foreign banking entities may not structure a transaction or activity so as to be "outside of the United States" for risk and booking purposes while simultaneously engaging in transactions within U.S. markets that are prohibited for U.S. banking entities.

In particular, § __.13(c)(3) of the proposed rule provides that a transaction or activity will be considered to have occurred solely outside of the United States only if all of the following three conditions are satisfied:

- The transaction or activity is conducted by a banking entity that is not organized under the laws of the United States or of one or more States;

³⁰⁶ The Board emphasizes that this clarification would be applicable solely in the context of sections 13(d)(1)(H) and (I) of the BHC Act. The application of section 4(c)(9) to such foreign companies in other contexts is likely to involve different legal and policy issues and may therefore merit different approaches.

³⁰⁷ See 12 U.S.C. 1843(c)(9); 12 CFR 211.23(a); proposed rule § __.13(c)(2). This difference reflects the fact that foreign entities subject to section 13 of the BHC Act but not the BHC Act are, in many cases, predominantly commercial firms. A requirement that a firm also demonstrate that more than half of its banking business is outside the United States would likely make the exemption unavailable to many such firms and subject their global activities to the prohibition on acquiring or retaining an ownership interest in, or acting as sponsor to, a covered fund, a result that the statute does not appear to have intended.

- No subsidiary, affiliate, or employee of the banking entity that is involved in the offer or sale of an ownership interest in the covered fund is incorporated or physically located in the United States; and
- No ownership interest in such covered fund is offered for sale or sold to a resident of the United States.

These three criteria reflect statutory constraints and are intended to ensure that a transaction or activity conducted in reliance on the exemption does not involve either investors that are residents of the United States or a relevant U.S. employee of the banking entity, as such involvement would appear to constitute a sufficient locus of activity in the U.S. marketplace so as to preclude the availability of the exemption.

A resident of the United States is defined in § __.2(t) of the proposed rule, and is described in detail in Part III.B.4.d of this Supplementary Information. The proposed rule applies this definition in the context of the foreign covered funds exemption because it would appear to appropriately capture the scope of counterparties (including investors that are residents of the United States) or relevant U.S. personnel of the banking entity, that, if involved in the transaction or activity, would preclude such transaction or activity from being considered to have occurred solely outside the United States. Under the proposed rule, an employee or entity engaged in the offer or sale of an ownership interest (or booking such transaction) must be outside of the United States; however, an employee or entity with no customer relationship and involved solely in providing administrative services or so-called “back office” functions to the fund as incident to the activity permitted under § __.13(c) of the proposed rule (such as clearing and settlement or maintaining and preserving records of the fund with respect to a transaction where no ownership interest is offered for sale or sold to a resident of the United States) would not be subject to this requirement.

iii. Request for comment.

The Agencies request comment on the proposed rule’s approach to implementing the foreign covered funds activity and investment exemption. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule’s implementation of the “foreign funds” exemption effective? If not, what alternative would be more effective and/or clearer?

Question [•]. Are the proposed rule’s provisions regarding when an activity will be considered to be conducted pursuant to section 4(c)(9) of the BHC Act effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Does it effectively address application of the foreign funds exemption to foreign banking entities not subject to the BHC Act generally? If not, how could it better address application of the exemption?

Question [•]. Are the proposed rule’s provisions regarding when a transaction or activity will be considered to have occurred solely outside the United States effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should additional

requirements be added? If so, what requirements and why? Should additional requirements be modified or removed? If so, what requirements and why or how?

Question [•]. Is the proposed exemption consistent with the purpose of the statute? Is the proposed exemption consistent with respect to national treatment for foreign banking organizations? Is the proposed exemption consistent with the concept of competitive equity?

Question [•]. Does the proposed rule effectively define a resident of the United States for these purposes? If not, how should the definition be altered? What definitions of resident of the United States are currently used by banking entities? Would using any one of these definitions reduce the burden of complying with section 13 of the BHC Act? Why or why not?

d. Sale and securitization of loans.

Section __.13(d) of the proposed rule permits a banking entity to acquire and retain an ownership interest in a covered fund that is an issuer of asset-backed securities, the assets or holdings of which are solely comprised of: (i) loans; (ii) contractual rights or assets directly arising from those loans supporting the asset-backed securities; and (iii) interest rate or foreign exchange derivatives that (A) materially relate to the terms of such loans or contractual rights or assets and (B) are used for hedging purposes with respect to the securitization structure.³⁰⁸ The authority contained in this section of the proposed rule would therefore allow a banking entity to engage in the sale and securitization of loans by acquiring and retaining an ownership interest in certain securitization vehicles (which could qualify as a covered fund for purposes of section 13(h)(2) of the BHC Act and the proposed rule) that the banking entity organizes and offers, or acts as sponsor to, in excess of and without being subject to the limitations contained in § __.12 of the proposed rule. Proposed § __.13(d) is designed to assist in implementing section 13(g)(2) of the BHC Act, which provides that nothing in section 13 of the BHC Act shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner otherwise permitted by law.³⁰⁹

The Agencies note that the phrase “materially relate to terms of such loans” is intended to quantitatively limit the derivatives permitted in a “securitization of loans” under § __.13(d) of the proposed rule to include only those derivatives where the notional amount of the derivative is tied to the outstanding principal balance of the loans supporting the asset-backed securities of such issuer, either individually or in the aggregate. Additionally, such derivatives must be used solely to hedge risks that result from a mismatch between the loans and the related asset-backed securities (e.g., fixed rate loans with floating rate asset-backed securities, loans tied to the Prime Rate with LIBOR asset-backed securities, or Euro-denominated loans with Dollar-denominated asset-backed securities). Therefore, § __.13(d)(3) of the proposed rule would not allow the use of a credit default swap by an issuer of asset-backed securities.

³⁰⁸ See proposed rule § __.13(d). The types of derivatives permitted under § __.13(d)(3) of the proposed rule are not meant to include a synthetic securitization or a securitization of derivatives, but rather to include those derivatives that are used to hedge foreign exchange or interest rate risk resulting from loans held by the issuer of asset-backed securities.

³⁰⁹ See 12 U.S.C. 1851(g)(2).

The Agencies request comment on the proposed rule's approach to implementing the rule of construction related to the sale and securitization of loans. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule's implementation of the statute's "sale and securitization of loans" rule of construction effective? If not, what alternative would be more effective and/or clearer?

Question [•]. Are there other entities or activities that should be included in the proposed rule's implementation of the rule of construction related to the sale and securitization of loans? If so, what entity or activity and why?

Question [•]. Is the proposed rule's application of the rule of construction contained in section 13(g)(2) of the BHC Act appropriate?

Question [•]. Are the proposed rule and this Supplementary Information sufficiently clear regarding which derivatives would be allowed in a "securitization of loans" under § __.13(d)(3) of the proposed rule? Is additional guidance necessary with respect to the types of derivatives that would be included in or excluded from a securitization of loans for purposes of interpreting the rule of construction contained in section 13(g)(2) of the BHC Act? If so, what topics should the additional guidance discuss and why?

Question [•]. Should derivatives other than interest rate or foreign exchange derivatives be allowed in a "securitization of loans" for purposes of interpreting the rule of construction contained in section 13(g)(2) of the BHC Act? Why or why not? What would be the legal and economic impact of not allowing the use of derivatives other than interest rate or foreign exchange derivatives in a "securitization of loans" under § __.13(d)(3) of the proposed rule for existing issuers of asset-backed securities and for future issuers of asset-backed securities?

Question [•]. Should the Agencies consider providing additional guidance for when a transaction with intermediate steps constitutes one or more securitization transactions that each would be subject to the rule? For example, both auto lease securitizations and asset-backed commercial paper conduits typically involve intermediate securitizations. The asset-backed securities issued to investors in such covered funds are technically supported by the intermediate asset-backed securities. Should these kinds of securitizations be viewed as a single transaction and included within a securitization of loans for purposes of the proposed rule? Should each step be viewed as a separate securitization?

6. Section __.14: Covered fund activities and investments determined to be permissible.

Section __.14 of the proposed rule, which implements section 13(d)(1)(J) of the BHC Act,³¹⁰ permits a banking entity to engage in any covered funds activity that the Agencies

³¹⁰ Section 13(d)(1)(J) of the BHC Act provides the Agencies discretion to determine that other activities not specifically identified by sections 13(d)(1)(A) – (I) of the BHC Act are exempted from the general prohibitions contained in section 13(a) of that Act, and are thus permitted activities. In order to make such a determination, the Agencies must find that such activity or activities promote and protect the safety and soundness of a banking entity, as well as promote and protect the financial stability of the United States. See 12 U.S.C. 1851(d)(1)(J).

determine promotes and protects the safety and soundness of a banking entity and the financial stability of the United States.³¹¹ Any activity authorized under § __.14 of the proposed rule must still comply with the prohibition and limitations governing relationships with covered funds contained in section 13(f) of the BHC Act, as implemented by § __.16 of this proposal.³¹² Additionally, like other activities permissible under section 13(d)(1) of the BHC Act and as implemented by subpart C of the proposed rule, activities found permissible under § __.14 of the proposed rule and section 13(d)(1)(J) remain subject to other provisions of section 13 of the BHC Act, including the sections limiting conflicts of interest and high-risk assets or trading strategies, as well as the section designed to prevent evasion of section 13 of the BHC Act.³¹³

The Agencies have proposed to permit three activities at this time under this authority. These activities involve acquiring or retaining an ownership interest in and sponsoring of (i) certain BOLI separate accounts; (ii) certain entities that, although within the definition of covered fund are, in fact, common corporate organizational vehicles; and (iii) a covered fund in the ordinary course of collecting a debt previously contracted in good faith or pursuant to and in compliance with the conformance or extended transition period provided for under the Board's rules issued under section 13(c)(6) of the BHC Act.

a. Investments in certain bank owned life insurance separate accounts.

Banking entities have for many years invested in life insurance policies that cover key employees, in accordance with supervisory policies established by the Federal banking agencies.³¹⁴ These BOLI investments are typically structured as investments in separate accounts that are excluded from the definition of "investment company" under the Investment Company Act by virtue of section 3(c)(1) or 3(c)(7) of that Act. By virtue of reliance on these exclusions, these BOLI accounts would be covered by the definition of "hedge fund" or "private equity fund" in section 13 of the BHC Act.³¹⁵

However, when made in the normal course, these investments do not involve the speculative risks intended to be addressed by section 13 of the BHC Act. Moreover, applying the prohibitions in section 13 to these investments would eliminate an investment that helps banking entities to reduce their costs of providing employee benefits as well as other costs.

³¹¹ See 12 U.S.C. 1851(d)(1)(J).

³¹² Section 13(d)(1)(J) of the BHC Act only provides the Agencies with the ability to provide additional exemptions from the prohibitions contained in section 13(a)(1) of the BHC Act. Section 13(f) of the BHC Act, which deals with relationships and transactions with a fund that is, directly or indirectly, organized and offered or sponsored by a banking entity, operates as an independent prohibition and set of limitations on the activities of banking entities. As such, § __.14 of the proposed rule cannot and does not provide any exemptions from the prohibition on relationships or transaction with a covered fund contained in section 13(f) of the BHC Act or § __.16 of the proposed rule.

³¹³ See 12 U.S.C. 1851(d)(2), (e)(1).

³¹⁴ See, e.g., Bank Owned Life Insurance, Interagency Statement on the Purchase and Risk Management of Life Insurance ("Interagency BOLI Guidance") (Dec. 7, 2004).

³¹⁵ See 12 U.S.C. 1851(h)(2).

Section __.14(a)(1) of the proposed rule permits a banking entity to acquire and retain these BOLI investments, as well as act as sponsor to a BOLI separate account.³¹⁶ The proposal includes a number of conditions designed to ensure that BOLI investments are not conducted in a manner that raises the concerns that section 13 of the BHC Act is intended to address. In particular, in order for a banking entity to invest in or sponsor a BOLI separate account, the banking entity that purchases the insurance policy: (i) may not control the investment decisions regarding the underlying assets or holdings of the separate account; and (ii) must hold its ownership interests in the separate account in compliance with applicable supervisory guidance provided by the appropriate Federal regulatory agency regarding BOLI.³¹⁷

The Agencies have structured this exemption in the proposed rule so as to allow a banking entity to continue to manage and structure its risks and obligations related to its employee compensation or benefit plan obligations in a manner that promotes and protects the safety and soundness of banking entities, which on an industry-wide level has the concomitant effect of promoting and protecting the financial stability of the United States.

b. Investments in certain other covered funds.

As noted above, the definition of “covered fund” as contained in § __.10(b)(1) of the proposed rule potentially includes within its scope many entities and corporate structures that would not usually be thought of as a “hedge fund” or “private equity fund.” Additionally, the Dodd-Frank Act contains other provisions that permit or require a banking entity to acquire or retain an ownership interest in or act as sponsor to a covered fund in a manner not specifically described under section 13 of the BHC Act.

Section __.14(a)(2) of the proposed rule permits a banking entity to own certain specified entities that are often part of corporate structures and that, by themselves and without other extenuating circumstances or factors, do not raise the type of concerns which section 13 of the BHC Act was intended to address but which nevertheless may be captured by the definition of “hedge fund” or “private equity fund” in section 13(h)(2) of the BHC Act. Specifically, § __.14(a)(2) of the proposed rule permits a banking entity to acquire or retain an ownership interest in or act as sponsor to (i) a joint venture between the banking entity and any other person, provided that the joint venture is an operating company and does not engage in any activity or any investment not permitted under the proposed rule; (ii) an acquisition vehicle,

³¹⁶ The proposed rule defines “separate account” as “an account established and maintained by an insurance company subject to regulation by a State insurance regulatory or a foreign insurance regulator under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.” See proposed rule § __.2(z).

³¹⁷ See proposed rule § __.14(a)(1)(i) – (ii). While other guidance or requirements may be imposed by the Agencies or an individual Agency for a specific banking entity for which it serves as the primary financial regulator, the Agencies note that, at a minimum, investments under authority of this section must comply with the Interagency BOLI Guidance. This guidance requires, among other things, that a banking entity generally: (i) not control the investment decisions regarding the underlying assets or holdings of the separate account; (ii) demonstrate to the satisfaction of the relevant Agency that the potential returns from the investments in such separate account are appropriately matched to the banking entity’s employee compensation or benefit plan obligations; and (iii) not use such separate account to take speculative positions or to support the general operations of the banking entity.

provided that the sole purpose and effect of such entity is to effectuate a transaction involving the acquisition or merger of one entity with or into the banking entity or one of its affiliates; and (iii) a wholly-owned subsidiary of the banking entity that is (A) engaged principally in providing bona fide liquidity management services described under § __.3(b)(2)(iii)(C) of the proposed rule, and (B) carried on the balance sheet of the banking entity.³¹⁸

The Agencies note that these types of entities may meet the definition of covered fund contained in § __.10(b)(1) of the proposed rule (and as contained in section 13(h)(2) of the BHC Act), to the extent these entities rely solely on section 3(c)(1) or 3(c)(7) of the Investment Company Act. However, these types of entities do not engage in the type and scope of activities to which Congress intended section 13 of the BHC Act to apply.³¹⁹ Additionally, without this exemption, many entities would be forced to alter their corporate structure without achieving any reduction in risk. Permitting such investments in these entities would thus appear to promote and protect the safety and soundness of banking entities and promote and protect the financial stability of the United States.

Section __.14(a)(2) of the proposed rule also permits a banking entity to comply with section 15G of the Exchange Act (15 U.S.C. 78o-11), added by section 941 of the Dodd-Frank Act, which requires a banking entity to maintain a certain minimum interest in certain sponsored or originated asset-backed securities.³²⁰ In order to give effect to this separate requirement under the Dodd-Frank Act, § __.14(a)(2)(iii) of the proposed rule permits a banking entity to acquire or retain an ownership interest in or act as sponsor to an issuer of asset-backed securities, but only with respect to that amount or value of economic interest in a portion of the credit risk for an asset-backed security that is retained by a banking entity that is a “securitizer” or “originator” in compliance with the minimum requirements of section 15G of the Exchange Act (15 U.S.C. 78o-11) and any implementing regulations issued thereunder.³²¹ The Agencies have structured this exemption to recognize that Congress imposed other requirements on firms that are banking entities under section 13 of the BHC Act. Additionally, permitting a banking entity to retain the minimum level of economic interest will incent banking entities to engage in more careful and prudent underwriting and evaluation of the risks and obligations that may accompany asset-backed securitizations, which would promote and protect the safety and soundness of banking entities and the financial stability of the United States.

Section 14(a)(2) of the proposed rule permits a banking entity to acquire and retain an ownership interest in a covered fund that is an issuer of asset-backed securities described in § 13(d) of the proposed rule, the assets or holdings of which are solely comprised of: (i) loans; (ii) contractual rights or assets directly arising from those loans supporting the asset-backed securities; and (iii) interest rate or foreign exchange derivatives that (A) materially relate to the terms of such loans or contractual rights or assets and (B) are used for hedging purposes with respect to the securitization structure. This exemption augments the authority regarding the sale

³¹⁸ See proposed rule § __.14(a)(2).

³¹⁹ See 156 Cong. Rec. H5226 (daily ed. June 30, 2010) (statement of Reps. Hymes and Frank).

³²⁰ The relevant agencies issued a proposed rule to implement the requirements of section 15G of the Exchange Act, as required under section 941 of the Dodd-Frank Act. See Credit Risk Retention, 76 FR 24090 (Apr. 29, 2011).

³²¹ See proposed rule § __.14(a)(2)(iii).

and securitization of loans available under § __.13(d) of the proposed rule (which partially implements the rule of construction under section 13(g)(2) of the BHC Act) and permits a banking entity to engage in the purchase, and not only the sale and securitization, of loans through authorizing the acquisition or retention of an ownership interest in such securitization vehicles that the banking entity does not organize and offer, or for which it does not act as sponsor, provided that the assets or holdings of such vehicles are solely comprised of the instruments or obligations referenced above.³²²

Permitting banking entities to acquire or retain an ownership interest in these loan securitizations will provide a deeper and richer pool of potential participants and a more liquid market for the sale of such securitizations, which in turn should result in increased availability of funds to individuals and small businesses, as well as provide greater efficiency and diversification of risk. The Agencies believe this exemption would promote and protect the safety and soundness of a banking entity, and would also promote and protect the financial stability of the United States.³²³

c. Acquiring or retaining an ownership interest in or acting a sponsor to a covered fund under certain specified authorities.

Section __.14(b) of the proposed rule permits a banking entity to acquire or retain an ownership interest in or act as sponsor to a covered fund in those instances where the ownership interest is acquired or retained by a banking entity (i) in the ordinary course of collecting a debt previously contracted in good faith, if the banking entity divests the ownership interest within applicable time periods provided for by the applicable Agency, or (ii) pursuant to and in compliance with the Conformance or Extended Transition Period authorities provided for under the proposed rule.³²⁴

Allowing banking entities to rely on these authorities for acquiring or retaining an ownership interest in or acting as sponsor to a covered fund will enable banking entities to manage their risks and structure their business in a manner consistent with their chosen corporate form and in a manner that otherwise complies with applicable laws. Thus, permitting such activities would promote and protect the safety and soundness of a banking entity, and would also promote and protect the financial stability of the United States.

d. Request for comment.

The Agencies request comment on the proposed rule's approach to implementing the exemption related to activities specifically determined to be permissible under section 13(d)(1)(J) of the BHC Act. In particular, the Agencies request comment on the following questions:

³²² See *id.* at § __.14(a)(2)(v).

³²³ The Agencies note that proposed exemption applies only to the covered fund-related provisions of the proposed rule, and not to its prohibition on proprietary trading.

³²⁴ See proposed rule § __.14(b). The Conformance or Extended Transition period authorities are substantially similar to those proposed by the Board in its February 2011 final rule governing such conformance periods under section 13 of the BHC Act.

Question [•]. Is the proposed rule's implementation of exemptions for covered fund activities and investments pursuant to section 13(d)(1)(J) of the BHC Act effective? If not, what alternative would be more effective and/or clearer?Question [•]. Are the proposed rule's provisions regarding when a covered fund activity will be deemed to be permitted under authority of section 13(d)(1)(J) of the BHC Act effective and sufficiently clear? If not, what alternative would be more effective and/or clearer?

Question [•]. Do the exemptions provided for in § __.14 of the proposed rule effectively promote and protect the safety and soundness of banking entities and the financial stability of the United States? If not, why not?

Question [•]. Are the proposed rule's provisions regarding what qualifications must be satisfied in order to qualify for an exemption under § __.14 of the proposed rule effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should additional requirements be added? If so, what requirements and why? Should additional requirements be modified or removed? If so, what requirements and why or how?

Question [•]. Does the proposed rule effectively cover the scope of covered funds activities which the Agencies should specifically determine to be permissible under section 13(d)(1)(J) of the BHC Act? If not, what activity or activities should be permitted? For additional activities that should be permitted, on what grounds would these activities promote and protect the safety and soundness of banking entities and the financial stability of the United States?

Question [•]. Does the proposed rule effectively address the interplay between the restrictions on covered fund activities and investments in section 13 of the BHC Act and the requirements imposed on certain banking entities under section 15G of the Exchange Act? Why or why not?

Question [•]. Rather than permitting the acquisition or retentions of an ownership interest in, or acting as sponsor to, specific covered funds under section 13(d)(1)(J) of the BHC Act, should the Agencies use the authority provided under section 13(d)(1)(J) to permit investments in a covered fund that display certain characteristics? If so, what characteristics should the Agencies consider? How would investments with such characteristics promote and protect the safety and soundness of the banking entity and promote the financial stability of the United States?

Question [•]. Should venture capital funds be excluded from the definition of "covered fund"? Why or why not? If so, should the definition contained in rule 203(l)-1 under the Advisers Act be used? Should any modification to that definition of venture capital fund be made? How would permitting a banking entity to invest in such a fund meet the standards contained in section 13(d)(1)(J) of the BHC Act?

Question [•]. Should non-U.S. funds or entities be included in the definition of "covered fund"? Should any non-U.S. funds or entities be excluded from this definition? Why or why not? How would permitting a banking entity to invest in such a fund meet the standards contained in section 13(d)(1)(J) of the BHC Act?

Question [•]. Should so-called “loan funds” that invest principally in loans and not equity be excluded from the definition of “covered fund”? Why or why not? What characteristics would be most effective in determining whether a fund invests principally in loans and not equity? How would permitting a banking entity to invest in such a fund meet the standards contained in section 13(d)(1)(J) of the BHC Act?

Question [•]. Are the proposed rule’s proposed determinations that the specified covered funds activities or investments promote and protect the safety and soundness of banking entities and the financial stability of the United States appropriate? If not, how should the determinations be amended or altered?

6. Section __.15: Internal Controls, reporting and recordkeeping requirements applicable to covered fund activities and investments.

Section __.15 of the proposed rule, which implements section 13(e)(1) of the BHC Act,³²⁵ requires a banking entity engaged in covered fund activities and investments to comply with (i) the internal controls, reporting, and recordkeeping requirements required under § __.20 and Appendix C of the proposed rule, as applicable and (ii) such other reporting and recordkeeping requirements as the relevant supervisory Agency may deem necessary to appropriately evaluate the banking entity’s compliance with this subpart C.³²⁶ These requirements are discussed in detail in Part III.D of this Supplementary information.

7. Section __.16: Limitations on relationships with a covered fund.

Section 13(f) of the BHC Act generally prohibits a banking entity from entering into certain transactions with a covered fund that would be a covered transaction as defined in section 23A of the FR Act.³²⁷ Section __.16 of the proposed rule implements this provision. Section __.16(a)(2) of the proposed rule clarifies that, for reasons explained in detail below, certain transactions between a banking entity and a covered fund remain permissible. Section __.16(b) of the proposed rule implements the statute’s requirement that any transaction permitted under section 13(f) of the BHC Act (including a prime brokerage transaction) between the banking entity and covered fund is subject to section 23B of the FR Act,³²⁸ which, in general, requires that the transaction be on market terms or on terms at least as favorable to the banking entity as a comparable transaction by the banking entity with an unaffiliated third party.

a. General prohibition on certain transactions and relationships.

Section 13(f)(1) of the BHC Act generally prohibits a banking entity that, directly or indirectly, serves as investment manager, investment adviser, commodity trading adviser, or sponsor to a covered fund (or that organizes and offers a covered fund pursuant to section

³²⁵ Section 13(e)(1) of the BHC Act requires the Agencies to issue regulations regarding internal controls and recordkeeping to ensure compliance with section 13. See 12 U.S.C. 1851(e)(1).

³²⁶ See proposed rule § __.15.

³²⁷ 12 U.S.C. 371c.

³²⁸ 12 U.S.C. 371c-1.

13(d)(1)(G) of the BHC Act) from engaging in any transaction with the covered fund, or with any covered fund that is controlled by such fund, if the transaction would be a “covered transaction” as defined in section 23A of the FR Act, as if the banking entity and any affiliate thereof were a member bank and the covered fund were an affiliate thereof.³²⁹ Section __.16(a)(1) of the proposed rule includes this prohibition.

Consistent with the requirements of section 13(f)(1) of the BHC Act, § __.16(a)(1) of the proposed rule is more restrictive than section 23A of the FR Act because § __.16(a)(1) generally prohibits a banking entity and any of its affiliates from entering into any such transaction, while section 23A permits covered transactions with affiliates so long as the transactions meet specified quantitative and qualitative requirements.³³⁰

b. Transactions that would be a “covered transaction”.

Section 13(f) of the BHC Act applies to covered transactions as defined in section 23A of the FR Act without incorporating any of the provisions in section 23A that provide exemptions from the prohibitions in that section for certain types of covered transactions.³³¹ Section __.16 of the proposed rule adopts the same language as the statute. The definition of “covered transaction” contained in section 23A of the FR Act itself includes an explicit exemption from the definition of “covered transaction” for “such purchase of real and personal property as may be specifically exempted by the Board by order or regulation.”³³² Since these transactions are, by definition, excluded from the definition of “covered transaction,” any transaction that is specifically exempted by the Board pursuant to this specific authority would not be deemed to be a covered transaction as defined in section 23A of the FR Act.

³²⁹ As noted above, the proposed rule implements the definition of “banking entity” in a manner that does not include covered funds for which a banking entity acts as sponsor or organizes and offers pursuant to section 13(d)(1)(G) of the BHC Act, or any covered fund in which such related covered fund invests. Accordingly, these covered funds (and any covered fund in which such covered fund acquired or retains a controlling investment) are not generally subject to the prohibitions contained in § __.16 of the proposed rule.

³³⁰ Section 23A of the FR Act limits the aggregate amount of covered transactions by a member bank to no more than (i) 10 per centum of the capital stock and surplus of the member bank in the case of any affiliate, and (ii) 20 per centum of the capital stock and surplus of the member bank in the case of all affiliates. See 12 U.S.C. 371c(a). Conversely, section 13(f) of the BHC Act operates as a general prohibition on such transactions without providing any similar amount of permitted transactions.

³³¹ The term “covered transaction” is defined in section 23A of the FR Act to mean, with respect to an affiliate of a member bank: (i) a loan or extension of credit to the affiliate, including a purchase of assets subject to an agreement to repurchase; (ii) a purchase of or an investment in securities issued by the affiliate; (iii) a purchase of assets from the affiliate, except such purchase of real and personal property as may be specifically exempted by the Board by order or regulation; (iv) the acceptance of securities or other debt obligations issued by the affiliate as collateral security for a loan or extension of credit to any person or company; (v) the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate; (vi) a transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a member bank or subsidiary to have credit exposure to the affiliate; or (vii) a derivative transaction, as defined in paragraph (3) of section 5200(b) of the Revised Statutes of the United States (12 U.S.C. 84(b)), with an affiliate, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate. See 12 U.S.C. 371c(b)(7), as amended by section 608 of the Dodd-Frank Act.

³³² Id. at 371c(b)(7)(C).

c. Certain transactions and relationships permitted.

While section 13(f)(1) of the BHC Act operates as a general prohibition on a banking entity's ability to enter into a transaction with a related covered fund that would be a covered transaction as defined under section 23A of the FR Act, other specific portions of the statute expressly provide for, or make reference to, a banking entity's ability to engage in certain transactions or relationships with such funds.³³³ Section __.16(a)(2) of the proposed rule implements and clarifies these authorities.

i. Permitted investments and ownerships interests.

Section __.16(a)(2) of the proposed rule clarifies that a banking entity may acquire or retain an ownership interest in a covered fund in accordance with the requirements of subpart C of the proposed rule.³³⁴ This clarification is proposed in order to remove any ambiguity regarding whether the section prohibits a banking entity from acquiring or retaining an interest in securities issued by a related covered fund in accordance with the other provisions of the rule, since the purchase of securities of a related covered fund would be a covered transaction as defined by section 23A of the FR Act. There is no evidence that Congress intended section 13(f)(1) of the BHC Act to override the other provisions of section 13 with regard to the acquisition or retention of ownership interests specifically permitted by the section. Moreover, a contrary reading would make these more specific sections that permit covered transactions between a banking entity and a covered fund mere surplusage.

ii. Prime brokerage transactions also permitted.

Section __.16(a)(2)(ii) of the proposed rule implements section 13(f)(3)(A) of the BHC Act, which provides that a banking entity may enter into any prime brokerage transaction with a covered fund in which a covered fund managed, sponsored, or advised by such banking entity has taken an ownership interest, so long as certain enumerated conditions are satisfied.³³⁵ The proposed rule defines "prime brokerage transaction" to mean one or more products or services provided by the banking entity to a covered fund, such as custody, clearance, securities borrowing or lending services, trade execution, or financing, and data, operational, and portfolio management support.³³⁶ To engage in a prime brokerage transaction with a covered fund pursuant to § __.16(a)(2)(ii) of the proposed rule, a banking entity must be in compliance with the limitations set forth in § __.11 of the proposed rule with respect to a covered fund organized and offered by such banking entity. In addition, as required by statute, the chief executive officer (or equivalent officer) of the banking entity must certify in writing annually that the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests. Finally, the Board must not have determined that such transaction is inconsistent with the safe and sound operation and condition of the banking entity.

³³³ See, e.g., 12 U.S.C. 1851(d)(1)(G), (d)(4), and (f)(3).

³³⁴ See proposed rule § __.16(a)(2)(i).

³³⁵ See proposed rule § __.16(a)(2)(ii).

³³⁶ See proposed rule § __.10(b)(4).

d. Restrictions on transactions with any permitted covered fund.

Section __.16(b) of the proposed rule implements sections 13(f)(2) and 13(f)(3)(B) of the BHC Act and applies section 23B of the FR Act³³⁷ to certain transactions and investments between a banking entity and a covered fund as if such banking entity were a member bank and such covered fund were an affiliate thereof.³³⁸ Section 23B provides that transactions between a member bank and an affiliate must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to such banking entity as those prevailing at the time for comparable transactions with or involving other unaffiliated companies or, in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliated companies.³³⁹

Section __.16(b) applies this requirement to transactions between a banking entity that serves as investment manager, investment adviser, commodity trading adviser, or sponsor to a covered fund and that fund and any other fund controlled by that fund. It also applies this condition to a permissible prime brokerage transaction in which a banking entity may engage pursuant to § __.16(a)(2)(ii) of the proposed rule.³⁴⁰

e. Request for comment.

The Agencies request comment on the proposed rule's approach to implementing the limitations on certain relationships with covered funds and, in particular, the manner in which the Agencies have proposed to apply a banking entity's ability to make explicitly permitted investments for these purposes, as described above. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule's approach to implementing the limitations on certain transactions with a covered fund effective? If not, what alternative approach would be more effective and why?

Question [•]. Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

Question [•]. What types of transactions or relationships that currently exist between banking entities and a covered fund (or another covered fund in which such covered fund makes a controlling investment) would be prohibited under the proposed rule? What would be the effect of the proposed rule on banking entities' ability to continue to meet the needs and demands of their clients? Are there other transactions between a banking entity and such covered funds that are not already covered but that should be prohibited or limited under the proposed rule?

³³⁷ 12 U.S.C. 371c-1.

³³⁸ See proposed rule § __.16(b).

³³⁹ 12 U.S.C. 371c-1(a); 12 CFR 223.51.

³⁴⁰ See 12 U.S.C. 1851(f)(2), (f)(3)(B); proposed rule § __.16(b).

Question [•]. Should the Agencies provide a different definition of “prime brokerage transaction” under the proposed rule? If so, what definition would be appropriate? Are there any transactions that should be included in the definition of “prime brokerage transaction”? Are there transactions or practices provided by banking entities that should be excluded in order to mitigate the burdens of complying with section 13 of the BHC Act?

Question [•]. With respect to the CEO (or equivalent officer) certification required under section 13(f)(3)(A) (ii) of the BHC Act and § __.16(a)(2)(ii)(B) of the proposed rule, what would be the most useful, efficient method of certification (e.g., a new stand-alone certification, a certification incorporated into an existing form or filing, website certification, or certification filed directly with the relevant Agency)?

8. Section __.17: Other limitations on permitted covered funds activities.

Section __.17 of the proposed rule implements section 13(d)(2) of the BHC Act, which places certain limitations on the permitted covered fund activities and investments in which a banking entity may engage. Consistent with the statute and § __.8 of the proposed rule, § __.17 provides that no transaction, class of transactions, or activity is permissible under §§ __.11 through __.16 of the proposed rule if the transaction, class of transactions, or activity would:

- Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;
- Result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or
- Pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.

Section __.17 of the proposed rule further defines “material conflict of interest,” “high-risk assets,” and “high-risk trading strategies for these purposes, which are identical to the definitions of the same terms for purposes of § __.8 of the proposed rule related to proprietary trading, and are described in detail in Part III.B.6 of this Supplementary Information.³⁴¹

The Agencies request comment on the proposed limitations on permitted covered fund activities and investments, including with respect to the questions in Part III.B.6 of the Supplementary Information as they pertain to covered fund activities and investments in particular.

³⁴¹ As noted in the discussion of the definition of “material conflict of interest in Part III.B.6 of this Supplementary Information, the proposed disclosure provisions of that definition are provided solely for purposes of the proposed rule’s definition of material conflict of interest, and do not affect a banking entity’s obligation to comply with additional or different disclosure or other requirements with respect to a conflict under applicable securities, banking, or other laws (e.g., section 27B of the Securities Act, which governs conflicts of interest relating to certain securitizations; section 206 of the Investment Advisers Act of 1940, which applies to conflicts of interest between investment advisers and their clients; or 12 CFR 9.12, which applies to conflicts of interest in the context of a national bank’s fiduciary activities).

D. Subpart D (Compliance Program Requirement) and Appendix C (Minimum Standards for Programmatic Compliance)

Subpart D of the proposed rule, which implements section 13(e)(1) of the BHC Act,³⁴² requires certain banking entities to develop and provide for the continued administration of a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on covered trading activities and covered fund activities and investments set forth in section 13 of the BHC Act and the proposed rule.³⁴³ This compliance program requirement forms a key part of the proposal's multi-faceted approach to implementing section 13 of the BHC Act, and is intended to ensure that banking entities establish, maintain and enforce compliance procedures and controls to prevent violation or evasion of the prohibitions and restrictions on covered trading activities and covered fund activities and investments.

1. Section __.20: Compliance program mandate.

The proposed rule adopts a tiered approach to implementing the compliance program mandate, requiring a banking entity engaged in covered trading activities or covered fund activities and investments to establish a compliance program that contains specific elements and, if the banking entity's activities are significant, meet a number of minimum standards. If a banking entity does not engage in covered trading activities and covered fund activities and investments, it must ensure that its existing compliance policies and procedures include measures that are designed to prevent the banking entity from becoming engaged in such activities and making such investments and must develop and provide for the required compliance program under proposed § __.20(a) of the proposed rule prior to engaging in such activities or making such investments, but is not otherwise required to meet the requirements of subpart D of the proposed rule.³⁴⁴

Section __.20(a) of the proposed rule contains the core requirement that each banking entity engaged in covered trading activities or covered fund activities and investments must establish, maintain and enforce a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading activities and covered fund activities and investments set forth in section 13 of the BHC Act and the proposed rule and that such program must be suitable for the size, scope, and complexity of activities and business structure of the banking entity. Section __.20(b) of the proposed rule specifies the following six elements that each compliance program established under subpart D must provide for, at a minimum:

- Internal written policies and procedures reasonably designed to document, describe, and monitor the covered trading activities and covered fund activities and investments of the banking entity to ensure that such activities and investments comply with section 13 of the BHC Act and the proposed rule;

³⁴² See 12 U.S.C. 1851(e)(1).

³⁴³ See proposed rule § __.20.

³⁴⁴ See proposed rule § __.20(d).

- A system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with section 13 of the BHC Act and the proposed rule in the banking entity's covered trading activities and covered fund activities and investments and to prevent the occurrence of activities that are prohibited by section 13 of the BHC Act and the proposed rule;
- A management framework that clearly delineates responsibility and accountability for compliance with section 13 of the BHC Act and the proposed rule;
- Independent testing for the effectiveness of the compliance program, conducted by qualified banking entity personnel or a qualified outside party;
- Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and
- Making and keeping records sufficient to demonstrate compliance with section 13 of the BHC Act and the proposed rule, which a banking entity must promptly provide to the relevant supervisory Agency upon request and retain for a period of no less than 5 years.

In addition, for a banking entity with significant covered trading activities or covered fund activities and investments, § __.20(c) requires the compliance program established under subpart D to meet a number of minimum standards, which are specified in Appendix C of the proposed rule. In particular, a banking entity must comply with the minimum standards specified in Appendix C of the proposed rule if:

- With respect to its covered trading activities, it engages in any covered trading activities and has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, (i) is equal to or greater than \$1 billion or (ii) equals 10 percent or more of its total assets; and
- With respect to its covered fund activities and investments, it engages in any covered fund activities and investments and either (i) has, together with its affiliates and subsidiaries, aggregate investments in one or more covered funds the average value of which is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than \$1 billion or (ii) sponsors or advises, together with its affiliates and subsidiaries, one or more covered funds the average total assets of which are, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than \$1 billion.

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

If a banking entity does not meet the thresholds specified in § __.20(c)(2), it need not comply with each of the minimum standards specified in Appendix C. However, the proposed rule would require such a banking entity to establish a compliance program that effectively

implements the six elements specified in § __.20(b). Banking entities engaged in a relatively small amount of covered fund activities are encouraged to look to the minimum standards of Appendix C for guidance. Generally, the Agencies would expect that the closer a banking entity is to the thresholds specified in § __.20(c)(2), the more its compliance program should generally include the specific requirements described in Appendix C. Within the bounds of subpart D and Appendix C, a banking entity has discretion to structure and manage its program for compliance with section 13 of the BHC Act and the proposed rule in a manner that best reflects the unique organization and operation of the banking entity and its affiliates and subsidiaries, and is suitable taking account of the size, scope, and complexity of activities in which the banking entity and its affiliates and subsidiaries engage.

As described above, § __.20(d) of the proposed rule clarifies that, if a banking entity does not engage in covered trading activities and/or covered fund activities or investments, it will have satisfied the requirements of this section if its existing compliance policies and procedures include measures that are designed to prevent the banking entity from becoming engaged in such activities or making such investments and which require the banking entity to develop and provide for the compliance program required under paragraph (a) of this section prior to engaging in such activities or making such investments.

2. Appendix C - minimum standards for programmatic compliance.

Appendix C of the proposed rule specifies a variety of minimum standards applicable to the compliance program of a banking entity with significant covered trading activities or covered fund activities and investments.³⁴⁵ Section I.a of proposed Appendix C sets forth the purpose of the required compliance program, which is to ensure that each banking entity establishes, maintains, and enforces an effective compliance program, consisting of written policies and procedures, internal controls, a management framework, independent testing, training, and recordkeeping, that:

- Is designed to clearly document, describe, and monitor the covered trading activities and covered fund activities or investments and the risks of the banking entity related to such activities or investments, identify potential areas of noncompliance, and prevent activities or investments prohibited by, or that do not comply with, section 13 of the BHC Act and the proposed rule;
- Specifically addresses the varying nature of activities or investments conducted by different units of the banking entity's organization, including the size, scope, complexity, and risks of the individual activity or investment;
- Subjects the effectiveness of the compliance program to independent review and testing;

³⁴⁵ The Agencies have proposed to include these minimum standards as part of the regulation itself, rather than as accompanying guidance, reflecting the compliance program's importance within the general implementation framework.

- Makes senior management and intermediate managers accountable for the effective implementation of the compliance program, and ensures that the board of directors or chief executive office (“CEO”) review the effectiveness of the compliance program; and
- Facilitate supervision of the banking entity’s covered trading activities and covered fund activities or investments by the Agencies.

A banking entity’s compliance program should not be developed through a generic, one-size-fits-all approach, but rather should carefully take into account and reflect the unique manner in which a banking entity operates, as well as the particular compliance risks and challenges that its businesses present. In light of the complexities presented in differentiating prohibited proprietary trading from permitted market making-related activities in particular, the Agencies expect that such a dynamic, carefully-tailored approach to internal compliance will play an important role in ensuring that banking entities comply with section 13’s prohibitions and restrictions. In addition, although this statement of purpose appears within the text of proposed Appendix C, the Agencies note the statement equally describes the general purpose of any compliance program required under subpart D of the proposed rule, regardless of whether proposed Appendix C specifically applies.

Section I.b of proposed Appendix C provides for several definitions used throughout the appendix, including the definition of “trading unit” and “asset management unit” to which the minimum standards apply. The term “trading unit” is defined in the same way as in Appendix A, as described in Part II.B.5 of the Supplementary Information, and is intended to identify multiple layers of a banking entity’s organizational structure because any effective compliance program will need to manage, limit and monitor covered trading activity at each such level of organization in order to effectively support compliance with the prohibition on proprietary trading. The term “asset management unit” is defined as any unit of organization of a banking entity that makes an investment in, acts as sponsor to, or has relationships with, a covered fund that the banking entity sponsors, organizes and offers, or in which a covered fund sponsored or advised by a banking entity invests.

Section I.c of proposed Appendix C incorporates by reference the six elements that must be included in the compliance program under § __.20 of the proposed rule, and section I.d describes the structure of a compliance program meeting the minimum standards. In particular, section I.d permits a banking entity to establish a compliance program on an enterprise-wide basis to satisfy the requirements of § __.20 of the proposed rule and the appendix, which program could cover the banking entity and all of its affiliates and subsidiaries collectively. In order to do so, the program must (i) be clearly applicable, both by its terms and in operation, to all such affiliates and subsidiaries, (ii) specifically address the requirements set forth in proposed Appendix C, (iii) take into account and address the consolidated organization’s business structure, size, and complexity, as well as the particular activities, risks, and applicable legal requirements of each subsidiary and affiliate, and (iv) be determined through periodic independent testing to be effective for the banking entity and its affiliates and subsidiaries. In addition, the enterprise-wide program would be subject to supervisory review and examination by any Agency vested with rulewriting authority under section 13 of the BHC Act with respect to the compliance program and the activities of any banking entity for which the Agency has such authority. Further, such Agency would have access to all records related to the enterprise-wide

compliance program pertaining to any banking entity that is supervised by the Agency vested with such rulewriting authority.

a. Internal policies and procedures.

Section II of proposed Appendix C articulates minimum standards for the first element of the compliance program, internal policies and procedures, for both covered trading activities and covered fund activities and investments. With respect to covered trading activities, the proposal would require that internal policies and procedures: (i) specify how the banking entity identifies its trading accounts; (ii) identify the trading activity in which the banking entity is engaged and how that activity is organized; (iii) thoroughly articulate the mission, strategy, risks, and compliance controls for each trading unit; (iv) include for each trader a mandate that describes the scope of his or her trading activity; (v) clearly articulate and document a comprehensive description of the risks associated with the trading unit's activities; (vi) document a comprehensive explanation of how the mission and strategy of the trading unit, and its related risk levels, comply with the proposed rule; and (vii) require the banking entity to promptly address and remedy any violation of section 13 of the BHC Act and the proposed rule. These internal policies and procedures would require banking entities to have the data and standards to prevent prohibited proprietary trading and to identify abnormalities and discrepancies that may be indicative of prohibited proprietary trading. The internal policies and procedures should also provide the Agencies with a clear, comprehensive picture of a banking entity's covered trading activities that can be effectively reviewed. With respect to covered fund activities and investments, the proposal would require that internal policies and procedures describe all covered fund activities in which the banking entity engages and the procedures used by the banking entity to ensure that it complies with the restrictions of section 13 of the BHC Act and the proposed rule.

The Agencies expect that these internal policies and procedures will be regularly reviewed and updated to reflect changes in business practices, strategies, or laws and regulations, though frequent, unexplained changes to policies and procedures or other aspects of the compliance program – particularly changes to reduce their stringency – would warrant additional scrutiny from banking entity management, independent testing personnel, and Agency supervisors or examiners.

b. Internal controls.

Section III of proposed Appendix C articulates minimum standards for the second element of the compliance program, internal controls. With respect to covered trading activities, the proposal would require internal controls that: (i) are reasonably designed to ensure that the covered trading activity is conducted in conformance with a trading unit's authorized risks, instruments and products, as documented in the banking entity's written policies and procedures; (ii) establish and enforce risk limits for each trading unit; and (iii) perform robust analysis and quantitative measurement of covered trading activity for conformance with section 13 of the BHC Act and the proposed rule. In particular, the banking entity must perform analysis and quantitative measurement that is reasonably designed to: (i) ensure that the activity of each trading unit is appropriate to the mission, strategy, and risk of each trading unit, as documented in the banking entity's internal written policies and procedures; (ii) monitor and assist in the

identification of potential and actual prohibited trading activity; and (iii) prevent the occurrence of prohibited proprietary trading. This analysis and measurement should incorporate the quantitative measurements calculated and reported under Appendix A of the proposed rule, but should also include other analysis and measurements developed by the banking entity that are specifically tailored to the business, risks, practices, and strategies of its trading units. The Agencies expect that the thoughtful use of these types of quantitative tools to monitor the extent to which the activities of a trading unit are consistent with its stated mission, strategy, and risk profile may help identify, for both banking entities and Agencies, abnormalities or discrepancies in permitted trading activity that may be indicative of prohibited proprietary trading. In addition, these internal controls must provide for regular monitoring of the effectiveness of the banking entity's compliance program and require the banking entity to take prompt action to address and remedy any deficiencies identified and to provide timely notification to the relevant Agency of any investigation and remedial action taken.

With respect to covered fund activities and investments, the internal controls required under section III of proposed Appendix C generally focus on ensuring that a banking entity has effective controls in place to monitor its investments in, and relationships with, covered funds to ensure its compliance with the covered fund activity and investments restrictions, including controls that relate to implementing remedies in the event of a violation of the requirements of section 13 of the BHC Act and the proposed rule.

c. Responsibility and accountability.

Section IV of proposed Appendix C articulates minimum standards for the third element of the compliance program, responsibility and accountability. These standards focus on four key constituencies – the board of directors, the CEO, senior management, and managers at each trading unit and asset management unit level. Section IV makes clear that the board of directors, or similar corporate body, and the CEO are responsible for creating an appropriate “tone at the top” by setting an appropriate culture of compliance and establishing clear policies regarding the management of covered trading activities and covered fund activities and investments. Senior management must be made responsible for communicating and reinforcing the culture of compliance established by the board of directors and the CEO, for the actual implementation and enforcement of the approved compliance program, and for taking effective corrective action, where appropriate. Managers with responsibility for one or more trading units or asset management units of the banking entity that are engaged in covered trading activity or covered fund activity and investments are accountable for effective implementation and enforcement of the compliance program for the applicable trading unit or asset management unit.

d. Independent testing.

Section V of proposed Appendix C articulates minimum standards for the fourth element of the compliance program, independent testing. A banking entity subject to the appendix must ensure that its independent testing is conducted by a qualified independent party, such as the banking entity's internal audit department, outside auditors, consultants or other qualified independent parties. The independent testing must examine both the banking entity's compliance program and its actual compliance with the proposed rule. Such testing must include not only the general adequacy and effectiveness of the compliance program and compliance

efforts, but also the effectiveness of each element of the compliance program and the banking entity's compliance with each provision of the proposed rule. This requirement is intended to ensure that a banking entity continually reviews and assesses, in an objective manner, the strength of its compliance efforts and promptly identifies and remedies any weaknesses or matters requiring attention within the compliance framework.

e. Training.

Section VI of proposed Appendix C articulates minimum standards for the fifth element of the compliance program, training. It proposes to require that a banking entity provide adequate training to its trading personnel and managers, as well as other appropriate personnel, in order to effectively implement and enforce the compliance program. In particular, personnel engaged in covered trading activities or covered fund activities and investments should be educated with respect to applicable prohibitions and restrictions, exemptions, and compliance program elements to an extent sufficient to permit them to make informed, day-to-day decisions that support the banking entity's compliance with the proposed rule and section 13 of the BHC Act. In particular, any personnel with discretionary authority to trade, in any amount, should be appropriately trained regarding the differentiation of prohibited proprietary trading and permitted trading activities and given detailed guidance regarding what types of trading activities are prohibited. Similarly, personnel providing investment management or advisory services, or acting as general partner, managing member, or trustee of a covered fund, should be appropriately trained regarding what covered fund activities and investments are permitted and prohibited.

f. Recordkeeping.

Section VII of proposed Appendix C articulates minimum standards for the sixth element of the compliance program, recordkeeping. Generally, a banking entity must create records sufficient to demonstrate compliance and support the operation and effectiveness of its compliance program (i.e., records demonstrating the banking entity's compliance with the requirements of section 13 of the BHC Act and the proposed rule, any scrutiny or investigation by compliance personnel or risk managers, and any remedies taken in the event of a violation or non-compliance), and retain these records for no less than five years in a form that allows the banking entity to promptly produce these records to any relevant Agency upon request. Records created and retained under the compliance program shall include trading records of the trading units, including trades and positions of each such unit.

g. Request for comment.

The Agencies request comment on the compliance program requirement contained in § __.20 of the proposed rule and the minimum standards specified in proposed Appendix C. In particular, the Agencies request comment on the following questions:

Question [•]. Is the proposed rule's inclusion of a compliance program requirement effective in light of the purpose and language of the statute? If not, what alternative would be more effective?

Question [•]. Is the proposed application of § __.20's compliance program requirement to all banking entities engaged in covered trading activity or covered trading investments and activities and the minimum standards of proposed Appendix C to only banking entities with significant covered trading or covered fund activities, effective? If not, what alternative would be more effective? Should proposed Appendix C apply to all banking entities? If so, why? Are the thresholds proposed for determining whether a banking entity must comply with proposed Appendix C appropriate? If not, what alternative would be more effective?

Question [•]. What implementation, operational, or other burdens or expenses might be associated with the compliance program requirement? How could those burdens or expenses be reduced or eliminated in a manner consistent with the purpose and language of the statute?

Question [•]. Do the proposed compliance program requirement and minimum standards provide sufficient guidance and clarity regarding how compliance programs should be structured? If not, what additional guidance or clarity is needed? Do the proposed compliance program requirement and minimum standards provide sufficient discretion to banking entities to structure a compliance program that appropriately reflects the unique nature of their businesses? If not, how could additional discretion be provided in a manner consistent with the purpose and language of the statute?

Question [•]. Are the six proposed elements of a required compliance program effective? If not, what alternative would be more effective? Should elements be added or removed? If so, which ones and why?

Question [•]. For each of the six proposed elements of a required compliance program for which minimum standards are provided in proposed Appendix C, are the proposed minimum standards effective? If not, what alternative would be more effective? Should minimum standards be added or removed? If so, which ones and why?

Question [•]. Does the requirement that a banking entity provide timely notification to the relevant Agency provide sufficient guidance as to what activities must be reported and how and when such reporting should be made? Should more specific standards be provided (e.g., regarding the timing of reporting and the types of activities that must be reported)? If so, what additional criteria should be implemented? Should the notification requirement be applied explicitly to banking entities that are not required to comply with the minimum standards specified in Appendix C because they are below the thresholds specified in § __.20(c)(2)? Why or why not?

Question [•]. Are there specific records that banking entities should be required to make and keep to document compliance with section 13 of the BHC Act and the proposed rule? Please explain.

Question [•]. What process should the Agencies use in determining whether to require a banking entity that, based on its size, would not be subject to Appendix C to comply with all or portions of the appendix under section I.e of the proposed appendix? What considerations should the Agencies take into account in making such a determination? Should this requirement

be implemented by an Agency order, by authority delegated to Agency staff, or a different method? Please explain.

Question [•]. Should the proposed rule permit banking entities to comply with Appendix C of the proposed rule on an enterprise-wide basis? If so, why? What are the advantages and disadvantages of an enterprise-wide compliance program? Should the proposed appendix provide additional clarity or discretion regarding how such an enterprise-wide program should be structured? If so, how? Please include a discussion relating to the infrastructure of an enterprise-wide compliance program and its management. If enterprise-wide compliance or similar programs are used in other contexts, please describe your experience with such programs and how those experiences influence your judgment concerning whether or not you would choose an enterprise-wide compliance program in this context.

Question [•]. Should the proposed rule permit banking entities to comply with § __.20(b) of the proposed rule on an enterprise-wide basis? If so, why? What are the advantages and disadvantages of an enterprise-wide compliance program for smaller banking entities that are not subject to Appendix C? Please include a discussion relating to the infrastructure of an enterprise-wide compliance program and its management in the context of smaller banking entities. If enterprise-wide compliance or similar programs are used in other contexts, please describe your experience with such programs and how those experiences influence your judgment concerning whether or not you would choose an enterprise-wide compliance program in this context. Are there particular reasons why a enterprise-wide compliance program should be permitted for larger banking entities subject to the requirements of Appendix C, but not those that are subject to § __.20(b) of the proposed rule?

Question [•]. What are the particular challenges that should be considered in connection with establishing a compliance program on an enterprise-wide basis? How will such challenges be addressed? Can an enterprise-wide compliance program be appropriately tailored to each of the subsidiaries and affiliates of a banking entity?

Question [•]. Are there efficiencies that can be gained through an enterprise-wide compliance program? If so, how and what efficiencies?

Question [•]. Would the complexities of various types of covered trading activity be adequately reflected in an enterprise-wide compliance program?

Question [•]. Should only outside parties be permitted to conduct independent testing for the effectiveness of the proposed compliance program to satisfy certain minimum standards? If so, why? Under the proposal, the independent testing requirement may be satisfied by testing conducted by an internal audit department or a third party. Should the rule specify the minimum standards for “independence” as applied to internal and/or external parties testing the effectiveness of the compliance program? For example, would an internal audit be deemed to be independent if none of the persons involved in the testing are involved with, or report to persons that are involved with, activities implicated by section 13 of the BHC Act? Why or why not?

Question [•]. Do you anticipate that banking entities that do not meet the thresholds specified in § __.20(c) would voluntarily comply with the proposed minimum standards in

Appendix C in order to effectively implement the six elements specified in §_.20(b)? Are there specific minimum standards that would not be practical or would be unattainable for a banking entity that does not meet the §__.20(c) thresholds? Please identify the minimum standard(s) and explain.

Question [•]. In light of the size, scope, complexity, and risk of covered trading activities, do commenters anticipate the need to hire new staff with particular expertise in order to establish, maintain, and enforce the proposed compliance program requirement concerning covered trading activities or any subset of covered trading activities?

Question [•]. With respect to the proposed requirement that training should occur with a frequency appropriate to the size and risk profile of the banking entity's covered trading activities and covered fund activities, should there be a minimum requirement that such training shall be conducted no less than once every twelve (12) months? If so, why?

Question [•]. Should proposed rule's Appendix C be revised to require a banking entity's CEO to annually certify that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program established pursuant to Appendix C in a manner that is reasonably designed to achieve compliance with section 13 of the BHC Act and this proposal? If so, why? If so, what would be the most useful, efficient method of certification (e.g., a new stand-alone certification, a certification incorporated into an existing form or filing, website certification, or certification filed directly with the relevant Agency)? Would a central data repository with a CEO attestation to the Agencies be a preferable approach?

Question [•]. Do the proposed rule requirements relating to establishment and implementation of a compliance program pose unique concerns or challenges to issuers of asset-backed securities that are banking entities, and if so, why? Are certain asset classes particularly impacted by the proposed rule requirements, and if so, how?

Question [•]. How would existing issuers of asset-backed securities that are banking entities pay for establishing and implementing a compliance program? Should existing issuers of asset-backed securities that cannot comply with the compliance program requirements be excluded from the proposed definition of "banking entity"? Should such exclusion be limited, and if so, based on what factors? Are the proposed thresholds specified in § __.20(c) of the proposed rule and/or the allowance of an enterprise-wide compliance program as set forth in Appendix C of the proposed rule sufficient to minimize these concerns for issuers of asset-backed securities?

Question [•]. With respect to future securitizations, what would be the impact of the establishment and implementation of the compliance program related to the provisions of the proposed rule as required by § __.20 of the proposed rule (including Appendix C, where applicable)? Are the proposed thresholds specified in § __.20(c) of the proposed rule and/or the allowance of an enterprise-wide compliance program as set forth in Appendix C of the proposed rule sufficient to minimize these concerns for issuers of asset-backed securities?

Question [•]. Would existing issuers of asset-backed securities that are banking entities be able to establish and implement a compliance program related to the provisions of the

proposed rule as required by § __.20 of the proposed rule (including Appendix C, where applicable)? If amendments to transactional documents are necessary, are there any obstacles that would make such amendments difficult to execute? If existing issuers of asset-backed securities cannot establish and implement a compliance program, what would be the impact on such existing issuers of asset-backed securities and the holders of securities issued by a non-compliant issuer of asset-backed securities? Is the allowance of an enterprise-wide compliance program as set forth in Appendix C of the proposed rule sufficient to minimize these concerns for issuers of asset-backed securities?

Question [•]. To rely on the exemptions for permitted underwriting, market making-related, and risk-mitigating hedging activities, the proposed rule requires banking entities to establish the internal compliance program under § __.20 and, where applicable, Appendix C, designed to ensure compliance with the requirements of the applicable exemption (e.g., policies and procedures, internal controls and monitoring procedures, etc.). Do these requirements in the proposed rule impose undue cumulative burdens, such that the marginal benefit of a given requirement is not justified by the cost that the requirement imposes? If so, why does the proposed rule impose cumulative burdens and what are the costs of those burdens? Please explain the circumstances under which these burdens may arise. Is there a way to reduce or eliminate such burdens or requirements in a manner consistent with the language and purpose of the statute? For any requirements that impose undue burdens, are there other requirements that could be substituted that would more efficiently ensure compliance with the statute? Are there any requirements that the proposed rule imposes that are particularly effective, and if so, how can the Agencies make better use of these requirements?

Question [•]. Are the six elements of the proposed compliance program requirement mutually reinforcing and cost effective, or are there redundancies in the six elements? Please explain any redundant requirements in the policies and procedures, internal controls, management framework, independent testing, training, and recordkeeping requirements in § __.20(b) of the proposed rule or proposed Appendix C. Why are such requirements redundant, and how should the redundancy be addressed and remedied in the rule?

Question [•]. A banking entity that meets the \$1 billion or greater trading assets and liabilities threshold would be required under the proposed rule to comply with both the reporting and recordkeeping requirements in Appendix A with respect to quantitative measurements and the compliance program requirement in Appendix C. Are the requirements in these appendices mutually reinforcing and cost effective, or do the appendices impose redundant requirements on banking entities that meet the \$1 billion threshold? Please explain any redundant requirements in the appendices and how such redundancy should be addressed and remedied in the rule.

Question [•]. Proposed Appendix C incorporates the quantitative measurements provided in proposed Appendix A in the internal controls requirement for banking entities that are engaged in covered trading activity and meet the \$1 billion or greater trading assets and liabilities threshold. Do the requirements in proposed Appendix A and Appendix C impose undue cumulative burdens with respect to any elements (e.g., quantitative measurements), such that the marginal benefit of a given requirement is not justified by the cost that the requirement imposes? Please explain why the proposed appendices impose cumulative burdens, the costs of those burdens, and the circumstances under which these burdens may arise. Is there a way to

reduce or eliminate such burdens or requirements in a manner consistent with the language and purpose of the statute? For any requirements in the appendices that impose undue burdens, are there other requirements that could be substituted that would more efficiently ensure compliance with the statute? Are there any requirements that the proposed appendices impose that are particularly effective, and if so, how can the Agencies make better use of these requirements?

3. Section __.21: Termination of activities or investments; penalties for violations.

Section __.21 of the proposed rule implements section 13(e)(2) of the BHC Act, which requires the termination of activities or investments that violate or function as an evasion of section 13 of the Act.³⁴⁶ In particular, § __.21(a) of the proposed rule requires any banking entity that engages in an activity or makes an investment in violation of section 13 of the BHC Act or the proposed rule or in a manner that functions as an evasion of the requirements of section 13 of the BHC Act or the proposed rule, including through an abuse of any activity or investment permitted under subparts B or C, or otherwise violates the restrictions and requirements of section 13 of the BHC Act or the proposed rule, to terminate the activity and, as relevant, dispose of the investment.³⁴⁷ Section __.21(b) of the proposed rule provides that if a relevant Agency finds reasonable cause to believe any banking entity has engaged in an activity or made an investment described in paragraph (a), the relevant Agency may, after due notice and an opportunity for hearing, by order, direct the banking entity to restrict, limit, or terminate the activity and, as relevant, dispose of the investment.³⁴⁸

E. Subpart E - Conformance Provisions

Section 13(c)(6) of the BHC Act required the Board, acting alone, to adopt rules implementing those provisions of section 13 of the BHC Act that provide a banking entity or a nonbank financial company supervised by the Board a period of time after the effective date of section 13 of the BHC Act to bring the activities, investments, and relationships of the banking entity or company that were commenced, acquired, or entered into before the effective date of section 13 of the BHC Act into compliance with that section and the agencies' implementing regulations.³⁴⁹ The Board's Conformance Rule, which was required under section 13(c)(6) of the BHC Act, was issued on February 8, 2011.³⁵⁰ As noted in its issuing release, this period is intended to give markets and firms an opportunity to adjust to section 13 of the BHC Act.³⁵¹

³⁴⁶ See 12 U.S.C. 1851(e)(2).

³⁴⁷ See proposed rule § __.21(a). The Agencies have proposed to include § __.21(a), in addition to the provisions of § __.21(b) of the proposed rule, to make clear that the requirement to terminate an activity or, as relevant, dispose of an investment would be triggered where a banking entity discovers a violation or evasion, regardless of whether an Agency order has been issued.

³⁴⁸ See proposed rule § __.21(b).

³⁴⁹ See 12 U.S.C. 1851(c)(6).

³⁵⁰ See Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 FR 8265 (Feb. 14, 2011).

³⁵¹ See id. (citing 156 Cong. Rec. S5898 (daily ed. July 15, 2010) (statement of Sen. Merkley)).

As part of the current proposal, the Board is proposing to relocate the Board's Conformance Rule, which was added as §§ 225.180-182 of the Board's Regulation Y, to subpart E of the Board's proposed rule.³⁵² The Board is also proposing to make certain conforming and technical changes to the language and defined terms of the Board's Conformance Rule in connection with its proposed relocation to subpart E of the Board's current proposal. The Board is not, however, proposing any substantive changes to the Board's Conformance Rule as part of this proposed rule. In particular, the Board's Conformance Rule defined certain terms related to section 13 of the BHC Act, including "banking entity," "hedge fund and private equity fund," "insured depository institution," and "Board."³⁵³ For the sake of consistency, the Board is proposing to eliminate these definitions as they are now defined elsewhere, and in more comprehensive a manner, in the proposed rule.³⁵⁴ These alternative or replacement definitions are substantially similar to those contained in the Board's Conformance Rule and are discussed in further detail in Part III.A.2 of this Supplementary Information.

In connection with incorporating provisions of the existing Board's Conformance Rule into the current proposal, the Board notes that the conformance period and extended transition period provided by section 13(c) of the BHC Act and the Board's Conformance Rule do not permit a banking entity to engage in any new activity or make any new investment in a covered fund without complying with the restrictions and prohibitions of section 13 of the BHC Act and implementing rules thereunder. The conformance period and extended transition period provided by the Board's Conformance Rule permit a banking entity to bring those of its existing activities and investments that do not conform to the requirements of section 13 of the BHC Act and the proposed rule into conformance. The Board's Conformance Rule does not authorize a banking entity to engage in new or additional prohibited activities or investments, and this restriction would continue to apply under the current proposed rule.

With respect to proprietary trading, the Board expects that each banking entity will identify those trading units of the banking entity that are engaged in prohibited proprietary trading as of or after the effective date of section 13 of the BHC Act and the type of proprietary trading in which they are engaged. A banking entity is expected to bring the prohibited proprietary trading activity of a trading unit into compliance with the requirements of the proposed rule as soon as practicable within the conformance period. A trading unit may not expand its activity to include prohibited proprietary trading after the effective date of the proposed rule. Similarly, a trading unit that is not identified as engaging in proprietary trading as of the effective date may not begin engaging in such activity after the effective date.

With respect to a covered fund activity or investment, the conformance period (or, in the case of an illiquid fund for which a banking entity has received Board approval, the extended transition period) generally permits a banking entity to retain an existing investment in a covered fund, make additional capital contributions to a covered fund if contractually obligated to do so,

³⁵² See Board proposed rule §§ __.30 to __.32.

³⁵³ See Board's Conformance Rule §§ 225.180(a) – (c), (e).

³⁵⁴ See proposed rule §§ __.2(e), (f), (p); __.10(b)(1).

or continue certain existing relationships with a covered fund.³⁵⁵ However, pursuant to the conformance period or extended transition period, a banking entity may not make a new investment or capital contribution that it is not contractually obligated to make in, or establish a new relationship with, a covered fund after the effective date of the proposed rule.³⁵⁶

Request for comment.

In light of the interplay between the Board's Conformance Rule and the current proposed rule, the Board is requesting comment on whether any of the conformance provisions should be revised. In particular, the Board requests comment on the following question:

Question [•]. Should any portion of the Board's Conformance Rule be revised in light of other elements of the current proposed rule? If so, why and how?

V. Request for Comments.

The Agencies are interested in receiving comments on all aspects of the proposed rule.

VI. Solicitation of Comments on Use of Plain Language

Section 722 of the Gramm-Leach-Bliley Act, Pub. L. 106-102, sec. 722, 113 Stat. 1338, 1471 (Nov. 12, 1999), requires the OCC, Board and FDIC to use plain language in all proposed and final rules published after January 1, 2000. The OCC, Board and FDIC invite public comments on how to make this proposal easier to understand. For example:

- Have we organized the material to suit your needs? If not, how could this material be better organized?
- Are the requirements in the proposed regulation clearly stated? If not, how could the regulation be more clearly stated?

³⁵⁵ For instance, under the Board's Conformance Rule and the current proposed rule, a banking entity may retain an existing ownership interest in a covered fund under authority of the conformance period or extended transition period without regard to the per-fund or aggregate fund limitations contained in § __.12 of the proposed rule. Additionally, a banking entity may continue to serve as sponsor to a covered fund under authority of the conformance period, but only if the banking entity acted as sponsor to such fund as of the effective date of section 13 of the BHC Act and the nature of the relationship was continuous. A banking entity may also serve as sponsor of an illiquid fund pursuant to the extended transition period, but only to the extent such service is related to the banking entity's retention of its permitted ownership interest in such fund.

³⁵⁶ In the case of a covered fund that a banking entity organizes and offers, or begins to act as sponsor to, after the effective date of section 13 of the BHC Act, the banking entity must comply with the requirements of the proposed rule with respect to its relationships with, and acquisition and retention of an ownership interest in, such covered fund. For instance, after the effective date of section 13 of the BHC Act, a banking entity may only acquire and retain an ownership interest in that covered fund as a permitted investment only (i) if the banking entity organizes and offers or acts as sponsor to that fund, and (ii) in compliance with the per-fund limitation and aggregate fund limitation of the proposed rule. Similarly, a banking entity's relationship with such covered fund would be subject to the limitations contained in the proposed rule.

- Does the proposed regulation contain language or jargon that is not clear? If so, which language requires clarification?
- Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes to the format would make the regulation easier to understand?
- What else could we do to make the regulation easier to understand?

VII. The Economic Impact of the Proposed Rule under Section 13 of the BHC Act — Request for Comment.

Section 13 of the BHC Act imposes on all banking entities prohibitions and restrictions on proprietary trading and certain interests in, and relationships with, a covered fund,³⁵⁷ which apply to banking entities whether or not the Agencies adopt implementing rules. In formulating the proposed rule to implement these provisions, which is required by statute, the Agencies have chosen a multi-faceted approach to establish a regulatory framework that provides for clear, robust, and effective implementation of the statute's provisions in a consistent manner, while also not unduly constraining the ability of banking entities to engage in permitted activities and investments.³⁵⁸ The Agencies have proposed this approach after considering the Council's findings and recommendations regarding how to implement section 13 of the BHC Act and a variety of alternatives described throughout this Supplemental Information.³⁵⁹

The Agencies recognize that there are economic impacts that may arise from the proposed rule and its implementation of section 13 of the BHC Act and invite comment on such impacts, including commenters' views on the potential economic impacts discussed in this Part of the Supplemental Information. In addition, the Agencies seek comment on whether the proposed rule represents a balanced and effective approach to implementing section 13 of the BHC Act or whether alternative approaches to implementing section 13 of the BHC Act exist that would provide greater benefits or involve fewer costs, consistent with the statutory purpose.

³⁵⁷ As noted above in connection with the conformance and extended transition periods, the proposed rule would not require an immediate application of these restrictions for any activity or investment entered into prior to the effective date of section 13 of the BHC Act (July 21, 2012). However, any activity or investment entered into after the effective date would be required to comply with section 13 of the BHC Act and the proposed rule, if adopted. See Supplemental Information Part III.E.

³⁵⁸ See Supplemental Information Part II.A.

³⁵⁹ See 12 U.S.C. 1851(b)(2)(A); see also Financial Stability Oversight Council, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds (Jan. 2011), available at <http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20org.pdf>.

We also request comment on the potential competitive effects of the statute and the proposed rule.³⁶⁰

In addition to the questions posed throughout Part II of the Supplemental Information with respect to the potential costs and benefits of particular aspects of the statute and proposed rule, in order to assist in the analysis of the economic impacts associated with the final rule and any alternatives the Agencies may evaluate, the Agencies encourage commenters to provide quantitative information about the rule's impact on banking entities, their clients, customers, and counterparties, specific markets or asset classes, and any other entities potentially affected by the proposed rule with respect to:

1. The direct and indirect costs and benefits of compliance with section 13 of the BHC Act, as proposed to be implemented;
2. The effect of section 13 of the BHC Act, as proposed to be implemented, on competition; and
3. Any other economic impacts of the proposal.

In addition, to assist with potential estimates of the proposed rule's quantitative impacts, we request specific comment on: (i) the extent to which banking entities currently engage in proprietary trading activity or covered funds activities or investments that are prohibited or restricted by the statute, or have otherwise divested or conformed such activities; and (ii) the potential costs and benefits or other quantitative impacts of various aspects of the statute and proposed rule, such as the compliance program requirement, the required reporting of quantitative measurements, and the conditions and requirements for relying on the proposed exemptions.

To further facilitate public comment on the economic effects of the statute and proposed rule, the Agencies have identified below a number of significant aspects of the proposed rule and potential economic impacts that may result from section 13 of the BHC Act's requirements, as proposed to be implemented. We seek commenters' views on the likelihood of the potential economic impacts identified in this Part and whether there are additional costs, benefits, or other impacts that may arise from the proposed rule. To the extent that such costs, benefits, or other impacts are quantifiable, commenters are encouraged to identify, discuss, analyze, and supply relevant data, information, or statistics related to such costs, benefits, and other impacts and the quantification of such costs, benefits, and other impacts. In addition, commenters are asked to identify or estimate start-up, or non-recurring, costs separately from costs or effects they believe would be ongoing.

A. Proprietary Trading Provisions

1. Definition of Trading Account

³⁶⁰ For example, implementation of section 13(d)(1)(H) of the BHC Act may result in a competitive advantage for foreign-controlled banking entities over U.S.-controlled banking entities with respect to activities that occur solely outside of the United States.

Section __.3 of the proposed rule, which implements the statutory definition of “trading account,” provides a multi-pronged definition of that term that is intended to ensure that banking entities do not engage in “hidden” proprietary trading by characterizing trading activity as being conducted outside a trading account. In addition to positions taken principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position, the proposed definition also includes: (i) with respect to a banking entity subject to the Federal banking agencies’ Market Risk Capital Rules, all positions in financial instruments subject to the prohibition on proprietary trading that are treated as “covered positions” under those capital rules, other than certain foreign exchange and commodities positions; and (ii) all positions acquired or taken by certain registered securities and derivatives dealers (or, in the case of financial institutions that are government securities dealers, that have filed notice with an appropriate regulatory agency) in connection with their activities that require such registration or notice. Although these prongs of the definition are proposed to prevent evasion of the statutory requirements, we seek comment on the extent to which either of these two prongs may create a competitive disadvantage for certain banking entities vis-à-vis competitors that are either not subject to section 13 of the BHC Act and/or competitors subject to different prongs of the proposed definition.

2. Exemption for Underwriting Activities

Section 13(d)(1)(B) of the BHC Act provides an exemption from the prohibition on proprietary trading for purchases and sales in connection with underwriting activities, to the extent that such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. In implementing this exemption in § __.4(a) of the proposed rule, the Agencies have endeavored to establish a regime that clearly sets forth the requirements for relying on the underwriting exemption established in the statute to facilitate banking entities’ compliance with the statutory requirements. In considering potential requirements for the underwriting exemption, and assessing the potential economic impacts of each such requirement, the Agencies strived to propose an appropriate balance between considerations related to: (i) the potential for evasion of the statutory prohibition on proprietary trading through misuse of the underwriting exemption; and (ii) the potential costs that may arise from constraints on legitimate underwriting activities.

The Agencies have proposed to use, wherever practicable, common terms from existing laws and regulations in the context of underwriting to facilitate market participants’ understanding and use of the exemption and to promote consistency across laws and regulations. Specifically, the proposed definitions of “distribution” and “underwriter” established in the proposed rule largely mirror the definitions provided for these terms in the SEC’s Regulation M. Because the proposed rule modifies the Regulation M definition of “underwriter” to include selling group members, the proposed definition would permit the current market practice of members of the underwriting syndicate entering into an agreement with other selling group members to collectively distribute the securities, rather than requiring all members of a distribution to join the underwriting syndicate.

In addition, the definition of “distribution” from Regulation M that the Agencies have proposed in § __.4(a) of the proposed rule is intended to ensure that the underwriting exemption

does not unduly constrain banking entities from providing underwriting services, while at the same time preventing banking entities from relying on the underwriting exemption to evade the proposed rule and the statutory prohibition on proprietary trading. The Agencies anticipate that the proposed approach to implementing the underwriting exemption should permit legitimate forms of underwriting in which market participants currently engage and, thus, should not unduly burden capital formation. In addition, the proposed rule would permit underwriters to continue to employ existing practices to stabilize a distribution of securities, which stabilization promotes confidence among issuers, selling security holders, and investors and further supports capital formation.

Under the proposed rule, the underwriting activities of a banking entity must be designed to generate revenues primarily from fees, commissions, underwriting spreads or other income, not from appreciation in value of covered financial positions that the banking entity holds related to such activities or the hedging of such covered financial positions. This proposed requirement should promote investor confidence by ensuring that the activities conducted in reliance on the underwriting exemption are designed to benefit the interests of clients seeking to bring their securities to market, not the interests of the underwriters themselves. The proposed requirement should also help prevent evasion of the statutory prohibition on proprietary trading, as trading activity designed to generate revenues from appreciation in the value of positions held by the banking entity would be indicative of prohibited proprietary trading, not underwriting activity. We seek comment on whether this approach of identifying underwriting activity by reference to revenue source could also make underwriting less profitable to the extent that it precludes or discourages certain types of profitability for bona fide underwriting services.

In addition to commenters' views on the potential economic impacts identified above, we request comment on whether the proposed rule may cause some banking entities to choose to decrease the supply of underwriting services in response to potential costs of the proposed rule and whether this result would adversely affect competition among underwriters or have a harmful impact on capital formation. In addition, if banking entities were to pass the increased costs of complying with the proposed exemption on to issuers, selling security holders, or their customers, we seek comment on whether the effect would be to increase the cost of raising capital and whether this would harm capital formation to the extent that such cost increases were sufficient to preclude issuers from accessing the capital markets. As described above, the Agencies have designed the proposal to balance such potential costs with provisions intended to permit banking entities' legitimate underwriting activities to continue as provided by the statute, while also establishing sufficient requirements to prevent evasion of the statutory goals through misuse of the underwriting exemption.

3. Exemption for Market Making-Related Activities

Section 13(d)(1)(B) of the BHC Act provides an exemption from the prohibition on proprietary trading for purchases and sales in connection with market making-related activities, to the extent that such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. In setting forth the requirements for eligibility for this exemption in § __.4(b) of the proposed rule, the Agencies have endeavored to establish a regime that clearly sets forth the requirements for relying on the exemption for market making-

related activity established in the statute to facilitate banking entities' compliance with the statutory requirements. In considering potential requirements for the market-making exemption, and assessing the potential economic impacts of each such requirement, the Agencies tried to strike an appropriate balance between considerations related to: (i) the potential for evasion of the statutory prohibition on proprietary trading through misuse of the exemption for market making-related activity; (ii) the potential difficulties related to distinguishing market making-related activity from prohibited proprietary trading; and (iii) potential costs that may arise from constraints on legitimate market making-related activities.

The Agencies have proposed to use, where practicable, terms and concepts used in current laws and regulations in the context of market making to promote clarity and consistency. Recognizing that there are differences in market making activities between different types of asset classes (e.g., liquid and illiquid instruments) and market structures (e.g., organized trading facilities and the over-the-counter markets), the Agencies have proposed to implement the market-making exemption in a manner that accounts for these distinctions and permits market making activities in different asset classes and market structures. Permitting legitimate market making in its different forms should promote market liquidity and efficiency by allowing banking entities to continue to provide customer intermediation and liquidity services in both liquid and illiquid instruments. The Agencies also recognize, however, that market making-related activities in the over-the-counter markets or activities involving less liquid instruments are sometimes less transparent than similar activities on organized trading facilities or in liquid markets. We seek comment on whether, in order to comply with the statutory prohibition on proprietary trading, some banking entities may be inclined to abstain from some market-making activities in an effort to reduce the risk of noncompliance. We also request comment on whether, if banking entities did so, this could result in reduced liquidity for certain types of trades or for certain less liquid instruments.

In addition, the proposed exemption permits anticipatory market making, block positioning, and hedging of market making positions under certain circumstances, which should further facilitate customer intermediation and market liquidity and efficiency. However, certain conditions are placed on such market making-related activities in the proposal in an effort to ensure that such activities are, in fact, market making-related activities, and are not hidden proprietary trading activities subject to the statutory prohibition.

The proposal requires that the market making-related activities be designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to appreciation in the value of covered financial positions a banking entity holds in trading accounts or the hedging of such positions. This proposed requirement should promote investor confidence by helping to ensure that market making serves customer needs. The proposed requirement should also help prevent evasion of the statutory prohibition on proprietary trading, as trading activity designed to generate revenues from appreciation in the value of positions held by the banking entity would be indicative of prohibited proprietary trading, not market making-related activity. The Agencies request comment on whether this approach of identifying market making activity by reference to a market making trading unit's revenue source would also make market making activity less profitable and whether it would preclude or discourage certain types of profitability for bona fide market making services. Commenters should also address whether this

requirement would reduce the willingness of some banking entities to continue to provide market making-related services and whether this could reduce liquidity, harm capital formation, or make market making-related services more expensive. The Agencies note that, in order to balance the potential for such effects with the statutory purpose, the proposed rule does not expressly prohibit all types of non-client income, and recognizes that the precise type and source of revenues generated by bona fide market making services can and will vary depending on the relevant market, asset, and facts and circumstances.

4. Exemption for Risk-Mitigating Hedging Activities

Section 13(d)(1)(C) provides an exemption from the prohibition on proprietary trading for risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings. The proposed exemption requires that the hedging transaction be reasonably correlated to these risks that the transaction is intended to hedge or otherwise mitigate. This proposed requirement is intended to address the potential for misuse of the exemption where a transaction is not closely tied to risk mitigation, while also providing some flexibility in the degree of correlation that is required in order to promote consistency with the statutory goals and requirements.

In addition, the proposed exemption requires that the hedging transaction: (i) not give rise, at the inception of the hedge, to significant exposures that are not themselves hedged in a contemporaneous transaction; and (ii) be subject to continuing review, monitoring, and management. Together, these proposed requirements are designed to ensure that a banking entity does not use the hedging exemption to conduct prohibited proprietary trading in the guise of hedging activity and to prevent evasion of the proprietary trading prohibition contained in section 13 of the BHC Act and the proposed rule. These proposed requirements are intended to ensure that an exempt hedging transaction will mitigate, not amplify, risk. Moreover, such requirements should further the goals of compliance with the statutory requirements and reducing banking entities' risks.

We seek comment on whether the proposed requirements for relying on the hedging exemption are more restrictive than necessary to implement the statutory language and purpose, and to prevent evasion of the statutory provisions, and whether a banking entity's hedging activities could be unduly constrained by the proposed rule. Further, commenters should address the extent to which a banking entity may be unable or unwilling to execute certain hedges and whether, as a result, a banking entity could be limited in its means to reduce its risk. In addition, would banking entities be dissuaded from engaging in other permitted activities or activities outside the scope of the statute (e.g., long-term investments) if the requirements of the proposed hedging exemption unduly limits or prevents them from mitigating the risks associated with such activities? We request comment on whether a reduction in efficiency could result from a reduced ability of covered banking entities to transfer risks to those more willing to bear them. Commenters should also address whether the proposed rule would reduce a banking entity's willingness to engage in permitted risk-mitigating hedging activities in order to avoid costs related to ensuring compliance with the exemption's requirements and whether this would

increase the banking entity's risk exposure. In order to balance the potential for such effects with the statutory purpose, the proposed rule attempts to implement the risk-mitigating hedging exemption in a manner that recognizes that the precise nature and execution of risk mitigation through hedging transactions can and will vary depending on the relevant market, asset, and facts and circumstances, while also establishing requirements designed to ensure that transactions relying on the hedging exemption are, in fact, hedges and not hidden proprietary trading prohibited by the statute.

The proposed exemption would require documentation with respect to hedges established at a different level of organization than that responsible for the underlying positions or risks that are being hedged. This proposed documentation requirement is intended to facilitate review by banking entities and Agency supervisors and examiners in assessing whether the hedge position was established to hedge or otherwise mitigate another unit's risks. Without such documentation, there could be an increased risk of evasion of the statute's prohibition on proprietary trading, as it would be difficult to assess whether a purported hedging transaction was established to mitigate another level of organization's risk or solely to profit from price appreciation of the position established by the purported hedge. We seek comment on the costs of the proposed documentation requirement for certain hedging transactions, such as the costs related to systems changes and maintenance, employee resources and time, and recordkeeping.³⁶¹ The Agencies also request comment on the extent to which the proposed documentation requirement would reduce the speed in which a banking entity could execute a hedge at a different level within the entity and whether this could reduce efficiency or result in a banking entity being exposed to a greater amount of risk. Further, we seek commenters' views on whether potentially slower execution times could also reduce profitability associated with the position as it remains unhedged (or, alternatively, increase profitability, depending on whether the value of the unhedged position is increasing or decreasing in the market). To balance the potential for such consequences with the statutory purpose, the Agencies have proposed to apply the documentation requirement to only a subset of hedging transactions that pose the greatest compliance risk (i.e., hedges that are established at a different level of organization than that establishing or responsible for the underlying positions or risks that are being hedged). In addition, the Agencies expect that the preparation of required documentation would become less burdensome and more efficient over time as systems are developed and personnel become more accustomed to the proposed requirement.

5. Compensation Related to Permitted Activities

The proposed rule would require that the compensation arrangements of persons performing underwriting, market making-related, and risk-mitigating hedging activities be designed not to reward proprietary risk-taking. These proposed requirements are intended to reduce incentives for personnel of the banking entity to violate the statutory prohibition on proprietary trading and expose the banking entity to risks arising from prohibited proprietary trading. We request comment on whether the proposed rule's requirements regarding

³⁶¹ The Agencies note that, for some costs of the proposed rule, hour burden estimates are provided in Part [internal cite to PRA] of this Supplementary Information for purposes of the Agencies' compliance with the Paperwork Reduction Act.

compensation arrangements would reduce the banking entity's ability to attract talented and experienced trading personnel or would harm the banking entity's ability to compete with entities that are not subject to section 13 of the BHC Act and the proposed rule. In order to balance the potential for such effects with the statutory goals, the proposed rule does not expressly prescribe how a banking entity must compensate its personnel or prohibit all types of compensation incentives related to non-client income, but instead proposes an approach that leaves banking entities with a degree of flexibility to compensate their personnel as they deem appropriate.

6. Exemption for Trading on Behalf of Customers

Section __.6(b) of the proposed rule implements section 13(d)(1)(D) of the BHC Act, which permits a banking entity, notwithstanding the prohibition on proprietary trading, to purchase or sell a covered financial position on behalf of customers. Because the statute does not define when a transaction would be conducted on behalf of customers, the proposed rule identifies three categories of transactions that would qualify under this exemption. By providing that only transactions meeting the terms of the three categories would be considered to be on behalf of customers for purposes of the exemption, the proposed rule addresses the potential for evasion of the statutory prohibition. At the same time, the proposed rule also would not permit banking entities to rely on the exemption with respect to other, unanticipated transactions that banking entities may undertake on behalf of customers. The Agencies seek comment on whether banking entities currently engage in principal transactions on behalf of customers that are not covered by the proposed exemption or other permitted activities and whether the lack of an exemption in the proposed rule for such activities would impact beneficial customer facilitation, market liquidity, efficiency, or capital formation.

7. Exemption for Trading Outside of the United States

Section __.6(d) of the proposed rule implements section 13(d)(1)(H) of the BHC Act, which permits certain foreign banking entities to engage in proprietary trading that occurs "solely outside of the United States." The proposed exemption provides a number of specific criteria for determining when trading will be considered to have occurred solely outside of the United States to help prevent evasion of the statutory restriction. The proposed exemption also provides a definition of "resident of the United States" that is similar to the SEC's definition of "U.S. person" in Regulation S, which should promote consistency and understanding among market participants that have experience with the concept from the SEC's Regulation S. In addition, the proposed exemption clarifies when a foreign banking entity will be considered to engage in such trading pursuant to sections 4(c)(9) and 4(c)(13) of the BHC Act, as required by the statute, including with respect to a foreign banking entity that is not a "foreign banking organization" under the Board's Regulation K. This implementation of section 13(d)(1)(H) of the BHC Act would permit certain foreign banking entities that are not "qualifying foreign banking organizations" under the Board's Regulation K to also rely on the exemption, notwithstanding the fact such foreign banking entities are not currently subject to the BHC Act generally or the Board's Regulation K. As a result, such foreign banking entities should encounter fewer costs related to complying with the proprietary trading prohibitions than if they were unable to rely on the exemption in section 13(d)(1)(H) of the BHC Act.

Despite the reference to section 4(c)(13) of the BHC Act, the statute provides that the exemption for trading outside of the United States is only available to banking entities that are not directly or indirectly controlled by U.S. banking entities (i.e., not any U.S. banking entities or their foreign subsidiaries and affiliates). Under the statute, the prohibition on proprietary trading applies to the consolidated, worldwide operations of U.S. firms. As required by statute, the proposal prohibits U.S. banking entities from engaging in proprietary trading unless the requirements of one or more relevant exemptions (other than the exemption for trading by foreign banking entities) are satisfied. As a result, the statute creates a competitive difference between the foreign activities of U.S. banking entities, which must monitor and limit their foreign activities in accordance with the requirements of section 13 of the BHC Act, relative to the foreign activities of foreign-based banking entities, which may not be subject to restrictions similar to those in section 13 of BHC Act. The Agencies seek commenters' views on whether the proposed rule's implementation of section 13(d)(1)(H) of the BHC Act imposes additional competitive differences, beyond those recognized above, and the potential economic impact of such competitive differences.

8. Quantitative Measurements

Section __.7 of the proposed rule, which implements in part section 13(e)(1) of the BHC Act,³⁶² requires certain banking entities to comply with the reporting and recordkeeping requirements specified in Appendix A of the proposed rule. Proposed Appendix A requires a banking entity with significant trading activities to furnish periodic reports to the relevant Agency regarding various quantitative measurements of its trading activities and create and retain records documenting the preparation and content of these reports. The proposed measurements would vary depending on the scope, type, and size of trading activities. In addition, proposed Appendix B contains a detailed commentary regarding the characteristics of permitted market making-related activities and how such activities may be distinguished from trading activities that, even if conducted in the context of banking entity's market making operations, would constitute prohibited proprietary trading. These proposed requirements are intended, in particular, to address some of the difficulties associated with (i) identifying permitted market making-related activities and distinguishing such activities from prohibited proprietary trading and (ii) identifying certain trading activities resulting in material exposure to high-risk assets or high-risk strategies. In combination, § __.7 and Appendix A of the proposed rule provide a quantitative overlay designed to help banking entities and the Agencies identify trading activities that warrant further analysis or review in a variety of levels and contexts.

The various quantitative measurements that would be required to be reported focus on assessing banking entities' risk management, sources of revenue, revenues in relation to risk, customer servicing, and fee generation. Aberrant patterns among the measurements with respect

³⁶² Section 13(e)(1) of the BHC Act requires the Agencies to issue regulations regarding internal controls and recordkeeping to ensure compliance with section 13. See 12 U.S.C. 1851(e)(1). Section __.20 and Appendix C of the proposed rule also implement section 13(e)(1) of the BHC Act.

to these areas would warrant further review to determine whether trading activities have occurred that are proprietary in nature and whether such activities may be exposing banking entities to disproportionate risk. For example, quantitative measurements should provide banking entities with a useful starting point for assessing whether their trading activities are consistent with the proposed rule and whether traders are exposing the entity to disproportionate risks. In addition, proposed Appendix A applies a standardized description and general method of calculating each quantitative measurement that, while taking into account the potential variation among trading practices and asset classes, is intended to facilitate reporting of sufficiently uniform information across different banking entities so as to permit horizontal reviews and comparisons of the quantitative profile of trading units across firms. This proposed approach, which recognizes that quantitative measurements must be applied with respect to differences within a banking entity's structure, business lines, and trading desks, should facilitate efficient application within firms and efficient examination across firms. The proposed use of a suite of quantitative measurements for these purposes may also limit erroneous indications of potential violations or erroneous indications of compliance (i.e., false positives and false negatives), thus allowing banking entities and examiners and supervisors to focus upon the measurements that may be most relevant in identifying prohibited conduct. The uniformity of the proposed measurements across different types of banking entities is also intended to ensure that banking entities are calculating comparable measurements consistently and that comparable measurements are being evaluated consistently by Agencies. The Agencies expect that as the implementation of quantitative measurements and the internal compliance and external oversight processes become more efficient over time, banking entities will find compliance efforts less burdensome.

The Agencies seek comment on the extent to which banking entities will incur costs associated with implementing, monitoring, and attributing financial and personnel resources for purposes of complying with the requirements of proposed Appendix A. Specifically, please discuss the extent to which banking entities are unlikely to currently calculate certain quantitative measurements in the manner required under the proposal (e.g., Spread Profit and Loss or Customer-facing Trade Ratio) and whether this may result in significant start-up costs associated with developing these measurements. Under the proposal, banking entities would also need to dedicate personnel and supervisory staff to review for potential aberrant patterns of activity that warrant further review, as well as maintain appropriate records of that review. In order to limit these calculation and surveillance costs to the greatest extent practicable, the Agencies have proposed measurements that, in many cases, are already calculated by many banking entities to measure and manage trading risks and activities. The costs to banking entities associated with calculating the proposed quantitative metrics should also be mitigated by the tiered application of Appendix A, which would require banking entities with the most extensive trading activities to report the largest number of quantitative measurements, while imposing fewer or no reporting requirements on banking entities with smaller trading activities. By limiting the application of aspects of Appendix A to firms with greater than \$1 billion in trading assets and liabilities, and all aspects of the appendix only to entities with greater than \$5 billion in trading assets and liabilities, the costs imposed should be proportional to the market reach and complexity of a banking entity's trading activities.

B. Covered Fund Activities

Subpart C implements the statutory provisions of section 13(a)(1)(B) of the BHC Act, which prohibit banking entities from acquiring or retaining any equity, partnership, or other ownership interest in, or sponsoring, a covered fund, and other provisions of section 13 of the BHC Act which provide exemptions from, or otherwise relate to, that prohibition. In implementing the covered funds provisions of section 13 of the BHC Act, the Agencies have proposed to define and interpret several terms used in implementing these provisions and the goals of section 13. We seek comment on whether the proposed rule represents a balanced and effective approach to implementing the covered fund provisions of the statute.

1. General Scope

For banking entities that invest in, sponsor or have relationships with one or more covered funds, the economic impact of complying with the statute and the implementing rule will vary, depending on the size, scope and complexity of their respective business, operations and relationships with clients, customers and counterparties. Moreover, the types of covered funds advised or sponsored by an adviser, the types of business and other relationships that an adviser may conduct with such funds and the adviser's other business activities, including relationships with other third party advised covered funds, will affect whether a covered fund activity would be subject to the statutory prohibition, eligible for a particular exemption or subject to particular internal control requirements as specified by the proposed rule.

For example, with respect to a banking entity that does not "sponsor," invest in, or otherwise provide "prime brokerage transactions" to, a "covered fund," the statute, as implemented by the proposed rule, would not substantively restrict the banking entity's activity; instead, the proposed rule would only require the minimum internal controls reasonably designed to prevent the entity from engaging in the prohibited activities. As a result, we do not expect that the proposed rule would have a significant effect on most banking entities, such as investment advisers, that are primarily engaged in providing bona fide trust, fiduciary, or advisory services to unrelated parties. Although such advisers may incur some incremental costs to develop and implement a compliance program reasonably designed to ensure that they do not engage in otherwise prohibited activities, there should be no significant costs associated with modifying existing business practices and procedures. We request comment on the extent to which such banking entities would be required to modify their existing business practices and procedures to comply with the proposed rule. For instance, would a registered investment adviser that only advises registered investment companies and that does not trade for its own account incur costs, benefits or other impacts in addition to costs to implement the minimum internal controls reasonably designed to prevent it from engaging in prohibited activities? Would an adviser that trades on behalf of itself incur, with respect to such trading activities, additional costs, benefits or other impacts described above relating to the proposed restrictions on proprietary trading?

In contrast, a banking entity that seeks to invest in a covered fund could only do so in reliance on an exemption specified in the statute or the proposed rule, such as the exemption for organizing and offering certain covered funds provided in section 13(d)(1)(G), as implemented in §.11 of the proposed rule. Similarly, a banking entity that seeks to enter into "prime brokerage transactions" with a covered fund could only do so by meeting certain requirements under the proposed rule. Accordingly, the economic impact of the proposed rule will depend on

whether an adviser's activities fall within the scope of the terms as proposed such that the banking entity would be subject to the limitations on covered fund activities. To the extent that these terms or exemptions would result in more, or fewer, activities being captured by the proposed rule, what are the attendant costs and benefits that a covered banking may incur? We request commenters provide empirical data where possible.

Definition of Covered Fund. The proposed rule's definition of "covered fund" includes hedge funds and private equity funds as defined by statute, but also identifies two types of similar funds – commodity pools and certain non-U.S. funds – that are subject to the covered fund restrictions and prohibitions of section 13 of the BHC Act, as implemented by the proposed rule. The Agencies have proposed to include these funds since they are generally managed and structured similar to a covered fund, but are not generally subject to the Federal securities laws due to the instruments in which they invest or the fact that they are not organized in the United States or one or more States. We request comment on whether applying the definition of covered fund in this way as proposed would increase the number of investment vehicles or similar entities that would be subject to the limitations under the proposed rule. Would this approach increase compliance costs for banking entities that sponsor, invest in, or have certain relationships with these types of funds?

The proposed rule also excludes certain types of investments in covered funds, pursuant to section 13(d)(1)(J) of the BHC Act, which authorizes the Agencies to exclude from the general covered fund activity prohibition those activities that would promote the safety and soundness of a banking entity. Section __.14 of the proposed rule would exclude from the prohibition, among other things, a banking entity's investments in covered funds related to bank owned life insurance, certain joint ventures and interests in securitization vehicles retained in compliance with the minimum credit risk retention requirements of section 15G of the Exchange Act. We request comment on the potential economic impact of the proposal to exclude these types of investments from the general prohibition. For banking entities whose only covered fund activities are those described in §__.14, what economic impact would be attributed to complying with this provision of the proposed rule? Would these costs and benefits differ from those of banking entities that conduct covered fund activities as well as engage in activities described in §__.14? As described in the Supplementary Information, a banking entity that generally does not engage in any prohibited activities is only required to adopt and implement a compliance program reasonably designed to ensure that the entity does not engage in prohibited activities. To what extent will the proposed provisions in §__.14 increase or mitigate any costs, benefits or other impacts associated with the foregoing minimum internal controls requirement?

Definition of Sponsor. Under the proposed rule, the term "sponsor" is defined by incorporating the definition set forth in section 13(h)(5) of the BHC Act, but the Agencies have proposed to clarify that the term trustee, as used in the definition of sponsor, does not include a trustee that does not provide discretionary investment services to a covered fund. This exception distinguishes a trustee providing non-discretionary advisory services from trustees providing services similar to those associated with entities serving as general partner, managing member, commodity pool operator or investment adviser of a covered fund. We request comment on the economic impact associated with the proposed definition of "sponsor." Will the economic impact differ depending on the scope of a banking entity's covered fund activities?

For example, a banking entity whose only relationship with a covered fund involves the provision of non-discretionary investment services would not be a sponsor under the proposed rule. We request comment on whether such a banking entity would benefit from this exception. We also request comment on whether a covered fund's investors and counterparties would bear any costs associated with a banking entity's modification of its business practices or its relationship to the covered fund.

Other Definitions. The covered fund provisions also define, among other things, "director" and "prime brokerage transaction." What are the costs, benefits or other impacts associated with the way the proposed rule defines these terms? For example, would the proposed definition of "prime brokerage transaction" enable a banking entity to provide services to a covered fund that would not ordinarily be understood to be prime brokerage as long as it met certain conditions? What costs, or benefits, for banking entities, clients, customers or counterparties may be associated with this approach to defining prime brokerage transaction?

2. Exemptions

In implementing the covered funds provisions of section 13 of the BHC Act, the Agencies also have interpreted or defined terms contained in the three principal exemptions related to covered fund activities by a banking entity: (i) the exemption for organizing and offering covered funds; (ii) the exemption for investment in a covered fund in the case of risk-mitigating hedging; and (iii) the exemption for covered fund activities outside of the United States. We request comment generally on the potential impact of these statutory exemptions, as implemented by the proposed rule. The Agencies note that there are multiple factors that could affect the impact of the statute and the proposed rule on a banking entity's covered fund activities, including other conditions set forth in the statute or the proposed rule that could mitigate costs or enhance benefits associated with a particular element or condition of an exemption.

Organize and Offer Exemption. Section __.11 of the proposed rule implements the exemption set forth in section 13(d)(1)(G) of the BHC Act and generally incorporates all of the conditions specified in the statute. As required by the statute, the exemption for organizing and offering covered funds is available only to banking entities that provide bona fide trust, fiduciary, commodity trading or investment advisory services, which must meet certain requirements. As a result, the exemption should not preclude banking entities, such as registered advisers or other advisers, from providing trust or advisory services to their clients. We request comment on whether the proposed requirements of the exemption would result in a banking entity modifying its business practices or bearing higher costs to comply with the limitations and requirements applicable to this statutory exemption, as implemented by the proposed rule. These costs may include, for example, developing a credible plan that documents how advisory services would be provided to banking entity customers through organizing and offering covered funds and making the specified disclosures required by the exemption. We also request comment on whether the banking entity will pass these costs on to covered fund investors and counterparties.

In implementing this statutory exemption, the Agencies have defined or clarified several key terms or requirements, including (i) the definition of ownership interest and (ii) the method

for calculating the 3% ownership interest limit. The proposed definition of ownership interest is designed to describe the typical types of relationships through which an investor has exposure to the profits and losses of a covered fund. Consistent with this approach, carried interest is not included within the proposed definition of ownership interest. As discussed in the Supplementary Information above, carried interest generally entitles service providers, such as banking entities that provide advisory services, to receive a portion of their compensation for such services in the form of a share of a covered fund's profits. As a result, the proposed rule does not treat carried interest as an ownership interest, which could have costs and benefits. To help discern these costs and benefits, we request comment on whether this is consistent with how providers of advisory services view the receipt of such "carried interest" (i.e., as compensation for services rather than as an "ownership interest" equivalent to an investor's interest that shares in a fund's profits and losses). The proposed definition of carried interest has limitations designed to prevent a banking entity from circumscribing the proposed rule's limitations on ownership. For instance, among other things, the proposed definition requires that the "sole purpose and effect of the interest is to allow banking entity . . . to share in the profits of the covered fund."³⁶³ For banking entities receiving compensation that would satisfy all of the elements of the proposed definition, there should be no burden associated with modifying existing business practices. For other banking entities, however, the conditions specified in the proposed definition could result in more banking entities being deemed to hold "ownership interests" and hence subject to the limitations under the statute and the proposed rule, including the limitations on material conflicts of interest, high-risk trading activities and exposure to high-risk assets. We request comment on whether these banking entities would need to modify their existing practices and develop alternatives, and, if so, whether these modifications will impose costs and benefits. For example, costs associated with modifying business practices could include developing and implementing a compliance program in accordance with the proposed rule; benefits that may arise as a result of modifying business practices could include limiting the extent to which material conflicts of interest may arise between clients, customer and counterparties of banking entities. We also request comment on whether such costs, if any, are likely to be passed on to fund investors, clients and counterparties.

As required by statute, a banking entity that seeks to invest in a covered fund under the exemption for organizing and offering covered funds could not, after the expiration of an initial one-year period (plus any applicable extensions), hold more than 3% of the total outstanding ownership interests of such fund. The proposed rule would require that a banking entity calculate the per-fund limit whenever the covered fund calculates its value or permits investor investments or redemptions, but in no case less frequently than quarterly. We request comment on whether this approach will limit any additional burden associated with calculating the per-fund limit for banking entities that invest in covered funds that determine their value on at least a quarterly basis. We also request comment on whether such banking entities will incur any additional significant costs in determining their compliance with the 3% ownership limitation.

Risk-mitigating Hedging Exemption. The proposed rule specifies an exemption from the general prohibition on covered fund activities in the case of risk-mitigating hedging. Similar to the hedging exemption in the case of proprietary trading (discussed above), the hedging

³⁶³ Proposed rule §__.10(b)(3)(i).

exemption for covered fund activities specifies a number of conditions that are identical except for two conditions. In the case of the hedging exemption for covered fund activities, the hedging must generally “offset” the exposure of the banking entity to the liabilities associated with (i) the facilitation of customer transactions or (ii) compensation arrangements for certain employees. Consistent with the statute, the proposed exemption would enable a banking entity to invest in a covered fund without limit if the investment is for risk-mitigating hedging purposes.

We request comment on whether the proposed requirements will have benefits of furthering the goals of compliance with the statute and reducing banking entities’ risks. We also request comment on whether the proposed requirements are more restrictive than necessary to implement the statute and whether they could unnecessarily limit a banking entity’s hedging activities and ability to reduce risk. Commenters should also address whether the proposed requirements will dissuade banking entities from engaging in other permitted activities (e.g., organizing and offering covered funds) or those activities outside the scope of the statute to the extent that the exemption prevents them from mitigating the risks associated with such activities. We request comment on whether a reduction in efficiency could result from a reduced ability of covered banking entities to transfer risks to those more willing to bear them. Commentators should also address whether the proposed rule could reduce a banking entity’s willingness to engage in permitted risk-mitigating hedging activities in order to avoid costs related to ensuring compliance with the exemption’s requirements, and whether this would increase the banking entity’s risk exposure.

Exemption for Covered Fund Activities Outside of the United States. Section __.13(c) of the proposed rule implements section 13(d)(1)(I) of the BHC Act, which permits certain foreign banking entities to sponsor or invest in covered funds “solely outside of the United States,” so long as the covered fund is not offered or sold to a resident of the United States. The proposed exemption provides a number of specific criteria for determining when a banking entity will be considered to have invested or sponsored a covered fund solely outside of the United States. The proposed exemption provides a definition of “resident of the United States” that is similar, but not identical, to the SEC’s definition of “U.S. person” in Regulation S, which should promote consistency and understanding among market participants that have experience with the concept from the SEC’s Regulation S. In addition, the proposed exemption clarifies when a foreign banking entity will be considered to engage in such trading pursuant to sections 4(c)(9) and 4(c)(13) of the BHC Act, as required by the statute, including with respect to a foreign banking entity that is not a “foreign banking organization” under the Board’s Regulation K. This implementation of section 13(d)(1)(I) of the BHC Act would permit certain foreign banking entities that are not “qualifying foreign banking organizations” under the Board’s Regulation K to also rely on the exemption, notwithstanding the fact such foreign banking entities are not currently subject to the BHC Act generally or the Board’s Regulation K. As a result, such foreign banking entities should encounter fewer costs related to complying with the covered fund activity prohibitions than if they were unable to rely on the exemption in section 13(d)(1)(I) of the BHC Act.

Despite the reference to section 4(c)(13) of the BHC Act, the statute provides that the exemption for covered fund activities outside of the United States is only available to banking entities that are not directly or indirectly controlled by U.S. banking entities (i.e., not any U.S.

banking entities or their foreign subsidiaries and affiliates). Under the statute, the prohibition and restrictions on covered fund activities apply to the consolidated, worldwide operations of U.S. firms. As required by statute, the proposal prohibits U.S. banking entities from investing in or sponsoring covered funds unless the requirements of one or more relevant exemptions (other than the exemption for trading by foreign banking entities) are satisfied. As a result, the statute creates a competitive difference between the foreign activities of U.S. banking entities, which must monitor and limit their foreign activities in accordance with the requirements of section 13 of the BHC Act, relative to the foreign activities of foreign-based banking entities, which may not be subject to restrictions similar to those in section 13 of BHC Act. The Agencies seek commenters' views on whether the proposed rule's implementation of section 13(d)(1)(I) of the BHC Act imposes additional competitive differences, beyond those discussed above, and the potential economic impact of such competitive differences.

3. Securitizations

The Agencies recognize that by defining "covered fund" and "banking entity" broadly, securitization vehicles may be affected by the restrictions and requirements of the proposed rule, and this may give rise to various economic effects. The Agencies preliminarily believe that the proposed rule should mitigate the impact of securitization market participants and investors in some non-loan asset classes (including, for example, banking entities that are participants in a securitization that may acquire or retain ownership interests in a securitization vehicle that falls within the definition of covered fund) by excluding loan securitizations from the restrictions on sponsoring or acquiring and retaining ownership interests in covered funds.

Costs may be incurred to establish internal compliance programs to track compliance for any securitization vehicle that falls within the definition of banking entity. These costs may be minimized for future securitization vehicles, however, because such securitizations may be able both to incorporate any internal compliance program requirements into their documentation prior to execution, and to minimize (or eliminate) any activities that may trigger greater compliance costs. The proposed rule should further minimize the costs of the internal compliance programs by (i) allowing for enterprise-wide compliance programs and minimal requirements for banking entities that do not engage in covered trading activities and/or covered fund activities or investments (each as described below), and (ii) allowing for reduced compliance program requirements by establishing financial thresholds for "significant" covered trading activities or covered fund activities or investments (as described below).

There could be initial costs both for banking entities that have an ownership interest in a securitization vehicle and for other securitization participants to determine if a particular vehicle falls within the definition of covered fund. Additional costs could be incurred to the extent that banking entities divest their ownership interests in any securitization vehicle that is a covered fund and is not otherwise eligible for one of the exceptions allowed under the proposed rule. This divestment could result in selling pressure that may have a negative impact on the market prices for the vehicles that fall within the definition of covered fund, which in turn could impact all investors in those securitization vehicles. Additionally, under the proposed rule banking entities would no longer be allowed to acquire and retain such ownership interests, which may result in

fewer potential investors and reduced liquidity in the market for ownership interests in these covered funds.

For example, the proposed rule could lead to significant potential market impacts if, with respect to an issuance of asset-backed securities secured by assets which are not loans, the market requires credit risk retention in excess of the minimum requirements to be adopted pursuant to Section 941 of the Dodd-Frank Act (i.e., the market believes that 5% credit risk retention is insufficient to address potential misalignment of incentives in a particular transaction). In such circumstances, the proposed rule could reduce potential investors' demand for such securitizations and could make such securitizations more expensive.

C. Limitations on Permitted Activities for Material Conflicts of Interest and High-Risk Assets and High-Risk Trading Strategies

Section 13(d)(2)(A)(i) of the BHC Act provides that an otherwise-permitted activity would not qualify for a statutory exemption if it would involve or result in a material conflict of interest. The proposed rule's definition of material conflict of interest, as discussed in more detail in Part II of the Supplemental Information, would provide flexibility to banking entities and their clients, customers, and counterparties with respect to how transactions are structured, while also establishing a structure to prevent banking entities from engaging in transactions and activities in reliance on a statutory exemption when the transaction or activity would have a materially adverse effect on the clients, customers, or counterparties of the banking entity. Specifically, the proposed definition would permit the use of timely and effective disclosure and/or information barriers in certain circumstances to address and mitigate conflicts of interest, while prohibiting transactions or activities where such a conflict of interest cannot be addressed or mitigated in the specified manner. The Agencies have endeavored to establish a workable definition that sets forth when a banking entity may not rely on an exemption because it would involve or result in a material conflict of interest, consistent with the statutory goals, to facilitate banking entities' compliance with the statutory requirements. We seek comment on whether the statutory prohibition, as implemented by the proposal, may impose costs on banking entities or their clients, customers, or counterparties. For instance, by permitting a client, customer or counterparty the option of negating or mitigating the conflict after the banking entity has disclosed the conflict, would the banking entity incur certain costs related to terminating the transaction, providing compensation or other means of mitigating the conflict, or administrative costs associated with negotiating the extent of any such compensation or other means of mitigating the conflict, depending on the actions of the client, customer, or counterparty in response to the disclosure?

In addition, section 13(d)(2)(A)(ii) of the BHC Act provides that an otherwise-permitted activity would not qualify for a statutory exemption if it would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies. This statutory limitation, as implemented in the proposed rule, would prevent a banking entity from engaging in certain high-risk activity. The Agencies request comment on whether the proposed definitions of high-risk asset and high-risk trading strategy would potentially reduce liquidity or create a reduction in efficiency for assets or markets related to that high-risk activity.

D. Compliance Program

Under § __.20 of the proposed rule, all covered banking entities that are engaged in covered trading activities or covered fund activities or investments would be required to have a compliance program that provides for the following six elements, at a minimum: (i) internal written policies and procedures; (ii) internal controls; (iii) a management framework; (iv) independent testing; (v) training; and (vi) recordkeeping. For those banking entities with significant covered trading activities or covered fund activities or investments under § __.20(c) of the proposed rule, additional standards in proposed Appendix C must be met with respect to these six elements.³⁶⁴ Collectively, the six proposed requirements would facilitate a banking entity's review and assessment of its compliance with section 13 of the BHC Act and the proposed rule, including identifying potential areas of deficiency in a banking entity's compliance program and providing the banking entity the opportunity to take appropriate corrective or disciplinary action, where warranted. The proposed compliance program would also facilitate Agency examination and supervision for compliance with the requirements of the statute and the proposed rule. By requiring that a banking entity have in place specific, documented elements (e.g., written policies and procedures and internal controls, recordkeeping requirements), the proposed rule would ensure that Agency examiners and supervisors can effectively review a banking entity's activities and investments to assess compliance and, where a banking entity is not in compliance with the proposed rule, take appropriate action.

Beyond the benefits recognized above, the individual elements of the proposed compliance program should also provide certain benefits. For example, the proposed management framework requirement is designed to give management a greater incentive to comply with the proposed rule and to ascertain that the employees they are responsible for overseeing are also complying with the proposed rule. Further, by establishing a management framework for compliance, the banking entity would be required to set a strong compliance tone at the top of the banking entity's organization and signal to its employees that management is serious about compliance, which should foster a strong culture of compliance throughout the banking entity. Similarly, the proposed independent testing requirement would provide a third-party assessment of a banking entity's compliance with the proposed rule, which should provide assurances to the banking entity, its clients, customers, and counterparties, and current or prospective investors that the banking entity is in compliance with the proposed rule. In addition, the proposed training requirement should help the various employees of a banking entity that have responsibilities and obligations under the proposed rule (e.g., complying with the requirements for permitted market making-related activity) understand such responsibilities and obligations and facilitate the banking entity's compliance with the proposed rule. This proposed requirement may also promote market confidence by assuring that trading personnel, and other appropriate personnel of the banking entity, are familiar with their regulatory responsibilities and are complying with the applicable laws and regulations in their interactions with clients, customers, and counterparties.

³⁶⁴ Proposed rule § __.20 and Appendix C implement section 13(e) of the BHC Act, which requires the Agencies to issue regulations regarding internal controls and recordkeeping to ensure compliance with section 13.

Because the six elements would be required to be established by all banking entities, other than those that are not engaged in covered trading activities or covered fund activities or investments, the proposed compliance program requirement should promote consistency across banking entities. However, the proposed elements are also intended to give a banking entity a degree of flexibility in establishing and maintaining its compliance program in order to address the varying nature of activities or investments conducted by different units of the banking entity's organization, including the size, scope, complexity, and risks of the activity or investment.

We seek comment on whether developing and providing for the continued administration of a compliance program under § __.20 of the proposed rule is likely to impose material costs on banking entities. Costs related to the proposed compliance program requirement are likely to be higher for those banking entities that are engaged in significant covered trading or covered fund activities or investments and, as a result, are required to comply with the more detailed, specific requirements of proposed Appendix C. Potential costs related to implementation of a compliance program under the proposal include those associated with: hiring additional personnel or other personnel modifications, new or additional systems (including computer hardware or software), developing exception reports, and consultation with outside experts (e.g., attorneys, accountants). The proposed compliance program requirement would also impose ongoing costs related to maintenance and enforcement of the compliance program elements, which may include those associated with: ongoing system maintenance, surveillance (e.g., reviewing and monitoring exception reports), recordkeeping, independent testing, and training. For example, the independent testing requirement in the proposal may necessitate that additional resources be provided to the internal audit department of the covered banking entity that is a registered broker-dealer or security-based swap dealer, if such testing is conducted by a qualified internal tester. Alternatively, if an outside party is used to conduct the independent testing, the covered banking entity would incur costs associated with paying the qualified outside party's for its services. The Agencies do not anticipate significant costs related to the proposed management framework requirement, as banking entities should already have relevant management structures in place.

The tiered approach with which the proposal applies the proposed compliance program requirement to banking entities of varying size should reduce the costs associated with developing and providing for the continued administration of a compliance program. In setting forth the proposed compliance program requirement in § __.20 of the proposed rule and Appendix C, the Agencies have taken into consideration the size, scope, and complexity of a banking entity's covered trading activities and covered fund activities and investments in developing requirements targeted to the compliance risks of large and small banking entities. Specifically, banking entities that do not meet the thresholds established in § __.20(c) of the proposed rule would not be required to comply with the more detailed and burdensome requirements set forth in Appendix C. In addition, banking entities that do not engage in covered trading activities and covered fund activities and investments would not be required to establish a compliance program under the proposed rule, and therefore should incur only minimal costs associated with adding measures to their existing compliance policies and procedures to prevent the banking entity from becoming engaged in such activities or making such investments. Together, these provisions have been proposed in order to permit a banking entity to tailor its

compliance program to its activities and investments and, where possible, leverage its existing compliance structures, all of which should minimize the incremental costs associated with establishing a compliance program under the proposed rule. However, banking entities that are engaged in significant covered trading and covered fund activities and investments and thereby present a heightened compliance risk due to the size and nature of their activities and investments would be required to comply with the additional standards set forth in proposed Appendix C.

Costs associated with the requirements of proposed Appendix C should also be reduced by aspects of the proposed rule that would permit a banking entity to establish an enterprise-wide compliance program under certain circumstances. An enterprise-wide compliance program would generally permit one compliance program to be established for a banking entity and all of its affiliates and subsidiaries collectively, rather than each legal entity being required to establish its own separate compliance program. The Agencies expect that an enterprise-wide compliance program should promote efficiencies and economies of scale, and reduce costs, associated with establishing separate compliance programs.

E. Additional Request for Comment

In addition to the requests for comment discussed above, we seek commenters' views on the following additional questions related to the potential economic impacts of the proposed framework for implementing section 13 of the BHC Act:

Question [•]. What are the expected costs and benefits of complying with the requirements of the proposed rule? We seek commenters' estimates of the aggregate cost or benefit that would be incurred or received by banking entities subject to section 13 of the BHC Act to comply. We also ask commenters to break out the costs or benefits of compliance to banking entities with each individual aspect of the proposed rule. Please provide an explanation of how cost or benefit estimates were derived. Please also identify any costs or benefits that would occur on a one time basis and costs that would recur. Would particular costs or benefits decrease or increase over time? If certain costs or benefits cannot be estimated, please discuss why such costs or benefits cannot be estimated.

Question [•]. Please identify any costs or benefits that would occur on a one-time basis and costs or benefits that would recur (e.g., training and compliance monitoring). Please identify any costs or benefits that you believe would decrease over time. Please identify any costs or benefits that you believe may increase over time or remain static.

Question [•]. Are there circumstances in which registered dealers, security-based swap dealers, and/or swap dealers (i) hold accounts other than trading accounts or (ii) hold investment positions for activities for which they are required to be registered? If so, would including all such dealer positions within the trading account definition create competitive burdens as well as additional burdens on the operations of such dealers that may not be consistent with the language and purpose of the statute? Please describe how this may occur, and to what extent it may occur.

Question [•]. Please identify the ways, if any, that banking entities might alter the ways they currently conduct business as a result of the costs that could be incurred to comply with the requirements of the proposed rule. Do you anticipate that banking entities will terminate any services or products currently offered to clients, customers, or counterparties due to the proposed rule, if adopted? Please explain.

Question [•]. How would trading systems and practices used in today's marketplace be impacted by the proposed rule? What would be the costs and/or benefits of such changes in trading practices and systems?

Question [•]. Would the proposed rule create any additional implementation or operational costs or benefits associated with systems (including computer hardware and software), surveillance, procedural, recordkeeping, or personnel modifications, beyond those discussed in the above analysis? Would smaller banking entities be disproportionately impacted by any of these additional implementation or operational costs?

Question [•]. We seek specific comments on the costs and benefits associated with systems changes on banking entities with respect to the proposed rule, including the type of systems changes necessary and quantification of costs associated with changing the systems, including both start-up and maintenance costs. We request comments on the types of jobs and staff that would be affected by systems modifications and training with respect to the proposed rule, the number of labor hours that would be required to accomplish these matters, and the compensation rates of these staff members.

Question [•]. Please discuss any human resources costs associated with the proposed rule, along with any associated overhead costs.

Question [•]. What are the benefits and costs associated with the requirements for relying on the underwriting exemption? What impact will these requirements have on capital formation, efficiency, competition, liquidity, price efficiency, if any? Please estimate any resulting benefits and costs or discuss why such benefits and costs cannot be estimated. What alternatives, if any, may be more cost-effective while still being consistent with the purpose and language of the statute?

Question [•]. What are the benefits and costs associated with the requirements for relying on the exemption for market making-related activity, including the requirement that such activity be consistent with the commentary in Appendix B? What impact will these requirements have on liquidity, price efficiency, capital formation, efficiency, and competition, if any? Please estimate any resulting benefits and costs or discuss why such benefits and costs cannot be estimated. What alternatives, if any, may be more cost-effective while still being consistent with the purpose and language of the statute?

Question [•]. What are the benefits and costs associated with the requirements for relying on the exemption for risk-mitigating hedging activity, including the requirement that certain hedge transactions be documented? What impact will these requirements have on liquidity, price efficiency, capital formation, efficiency, and competition, if any? Please estimate any resulting

benefits and costs or discuss why such benefits and costs cannot be estimated. What alternatives, if any, may be more cost-effective while still being consistent with the purpose and language of the statute?

Question [•]. Are there traditional risk management activities of banking entities that are not covered by the liquidity management and risk-mitigating hedging exemptions as currently proposed? What risks do banking entities face that go beyond market, counterparty/credit, currency/foreign exchange, interest rate, and basis risk?

Question [•]. To rely on the exemptions from the proposed rule for permitted underwriting, market making-related activity, and risk-mitigating hedging, banking entities must establish, maintain, and enforce a compliance program, including written policies and procedures and internal controls. Please discuss how the costs incurred, or benefits received, by banking entities related to initial implementation and ongoing maintenance of the compliance program would impact their customers and their businesses with respect to underwriting, market making, and hedging activity.

Question [•]. Please discuss benefits and costs related to the limitations on permitted activities for material conflicts of interest, high-risk assets and trading strategies, and threats to the safety and soundness of banking entities or to the financial stability of the U.S in the proposed rule. Are there particular benefits and costs related to the proposed definitions of material conflict of interest, high-risk asset, and high-risk trading strategy in the proposed rule? Would these definitions have any unintended costs, such as creating undue burdens and limitations on permitted underwriting, market making-related, or hedging activity? Please explain. What alternatives, if any, may be more cost-effective while still being consistent with the purpose and language of the statute?

Question [•]. Please discuss the benefits and costs related to the definition of derivative in the proposed rule and the application of the restrictions on proprietary trading to transactions in the different types of derivatives covered by the definition. What alternatives, if any, may be more cost-effective while still being consistent with the purpose and language of the statute?

Question [•]. What costs and benefits would be associated with calculating, reviewing, and analyzing the proposed quantitative measurements? What costs and benefits would be associated with reporting the proposed quantitative measurements to an Agency? Please identify any of the proposed quantitative measurements that are already reported to an Agency and discuss whether the current reporting regime would mitigate costs associated with the proposed rule. With respect to any quantitative measurement that is not already reported to an Agency, what are the costs and benefits of beginning to report the measurement? Would banking entities have to create or purchase new systems or implement changes to existing systems in order to report these quantitative measurements? Please discuss the costs and benefits associated with such systems changes.

Question [•]. How much of the data necessary to calculate the quantitative measurements in Appendix A is currently captured, retained, and utilized by banking entities? If the applicable data is not currently used by banking entities, is it readily available? Is it possible to collect all

of the data that is necessary for calculating the required measurements? Please identify any data that banking entities do not currently utilize that would need to be captured and retained for purposes of proposed Appendix A and discuss the costs and benefits of capturing and retaining such data.

Question [•]. Do the costs and benefits of calculating, analyzing, and reporting certain or all quantitative measurements differ between trading units and their trading activities, including trading strategies, asset classes, market structure, experience and market share, and market competitiveness? Are any quantitative measurements particularly costly to calculate or analyze for specific trading activities or, alternatively, particularly beneficial? If so, which quantitative measurement, what type of trading activity, and what factor(s) of that trading activity makes the quantitative measurement particularly costly or beneficial? Please discuss how these costs, if any, could be mitigated or benefits, if any, could be enhanced.

Question [•]. The proposed definition of trading unit would require a tiered approach to calculating and reporting quantitative measurements, such that the measurements would be calculated and reported for different levels within the banking entity, with higher levels encompassing smaller units (e.g., trading desks, business lines, and all trading operations). What are the costs and benefits of calculating the quantitative measurements for each level within the definition of trading unit? Can the higher level calculations incorporate the lower level calculations such that the higher level calculations result in small, incremental costs? Why or why not? Are there particular costs or benefits associated with calculating, analyzing, and reporting a quantitative measurement at one of the levels within the definition of trading unit that would not be experienced at the other levels? Please explain. What are the costs, if any, of “noise,” “false positives,” or “false negatives” with respect to the quantitative measurements and calculations at different levels? Can these costs be mitigated and, if so, how? What alternatives, if any, may be more cost-effective while still being consistent with the purpose and language of the statute?

Question [•]. We seek comment on whether the requirement that banking entities employ a suite of quantitative measurements may lead to redundancies and/or inefficiencies in the application of the measurements for some types of trading units within some banking entities. Despite the flexibility of Appendix A via recognition that quantitative measurements will be applied with respect to differences within a banking entity’s structure, business lines, and trading desks, we seek comment on whether the requirement of a mandatory suite of quantitative measurements may prove burdensome. For instance, is the application of certain quantitative measurements not efficient, appropriate, or calculable for certain asset classes or trading units or would the benefits of applying such quantitative measurements be negligible in relation to the costs of applying such measurements? In addition, would the overlay divert a banking entity from allocating resources toward quantitative – or other – measurements that might prove more useful and better tailored to its specific and unique trading practices?

Question [•]. What are the benefits and costs of the recordkeeping requirement in proposed Appendix A? Please explain and quantify, to the extent possible. To what extent would the proposed recordkeeping requirement impose new or additional costs and benefits beyond the current recordkeeping obligations of different types of banking entities (e.g.,

affiliated broker-dealers, affiliated investment advisers, insured depository institutions, etc.)? What alternatives, if any, may be more cost-effective while still being consistent with the purpose and language of the statute?

Question [•]. Please identify any cost savings that would be achieved through the use of an enterprise-wide compliance program. Alternatively, would you expect certain costs to increase when using an enterprise-wide compliance program? Please explain. Please identify any benefits that might be amplified or reduced when using an enterprise-wide compliance program.

Question [•]. Are there tools or elements in the contents of the compliance program set forth in § __.20(b) for which the costs may be negligible because banking entities use the same or similar elements for other purposes (e.g., satisfying other regulatory requirements, risk management, etc.) and could utilize existing infrastructure for purposes of the proposed rule? For example, could existing trader mandates or an existing training program be expanded to meet the requirements of the proposed rule, rather than developing an entirely new infrastructure? Alternatively, would the proposed rule require redundancies or duplications within a banking entity's infrastructure (e.g., the trader mandates currently used for one purpose do not conform to the requirements of the proposed rule, so a banking entity would have to utilize both in different circumstances)? Please identify and explain any such redundancies and how the rule could be modified to reduce or eliminate such redundancies, if possible.

Question [•]. How would the proposed rule affect compliance costs (e.g., personnel or system changes) or benefits for each category of banking entity: small, medium, and large? Please discuss any differences between the costs and benefits of the compliance program required under § __.20(b) for smaller banking entities and the compliance program requirements of Appendix C for larger banking entities. Are the differences between these benefits and costs justified due to the differences in size and complexity of smaller and larger banking entities?

Question [•]. The definition of trading unit in proposed Appendix C covers different levels of a banking entity and, as a result, requires a tiered approach to establishing, maintaining, and enforcing the compliance program requirements with respect to covered trading activities. What are the costs and benefits of applying the compliance program requirements at several levels within the banking entity? To what extent does the ability to incorporate written policies and procedures of lower-level units by reference, rather than establishing separate written policies and procedures, mitigate the costs of the proposed requirements? Are there other ways that the proposed requirements could be made more cost-effective for the different levels within the banking entity?

Question [•]. How will the proposed definition of "covered fund" affect a banking entity's investment advisory activities, in particular activities and relationships with investment funds that would be treated as "covered funds"? Please estimate any resulting costs or benefits or discuss why such costs or benefits cannot be estimated.

Question [•]. How have banking entities traditionally organized and offered covered funds? What are the benefits and costs associated with the proposed requirements for relying on

the exception for organizing and offering covered funds? Please estimate any resulting costs or benefits or discuss why such costs or benefits cannot be estimated.

Question [•]. What are the costs and benefits associated with the way the proposed rule implements the “customers of such services” requirement in the exception for organizing and offering covered funds? What alternative, if any, may be more cost-effective while still being consistent with the language and purpose of the statute?

Question [•]. Is it common for a banking entity to share a name with the covered funds that it invests in or sponsors? If yes, what entity in the banking structure typically shares a name with such covered funds? What costs and benefits will result from the proposed rule’s implementation of the name sharing requirement in exception for organizing and offering a covered fund? What alternatives, if any, may be more cost-effective while still being consistent with the purpose of the statute?

Question [•]. Under what circumstances do directors and employees of a banking entity invest in covered funds? What are the benefits and costs associated with the proposed provisions regarding director and employee investments in covered funds? What alternatives, if any, may be more cost-effective while still being consistent with the purpose of the statute?

Question [•]. Do banking entities currently invest in or sponsor SBICs and public welfare and qualified rehabilitation investments? If yes, to what extent? What are the benefits and costs associated with the proposed rule’s implementation of the exception for investment in SBICs and public welfare and qualified rehabilitation investments?

Question [•]. Do banking entities currently invest in or sponsor each of the vehicles that the proposed rule permits banking entities to continue to invest in and sponsor under section 12(d)(1)(J) of the BHC Act? If yes, to what extent? What are the benefits and costs associated with the proposed rule’s implementation of these exceptions?

Question [•]. For banking entities that are affiliated investment advisers, are there additional costs or benefits to complying with section 13 of the BHC Act and the proposed rule? For example, do affiliated investment advisers typically maintain records that would enable them to demonstrate compliance with the 3% ownership limits or restrictions on transactions that would be subject to sections 23A and 23B of the FR Act?

Question [•]. Would complying with section 13 of the BHC Act and the proposed rule affect an affiliated investment adviser’s other business activities (benefit or burden) that are not subject to restrictions on proprietary trading or other covered fund activities? For example, would advisers incur additional burdens to distinguish covered fund activities from non-covered fund activities?

Question [•]. For banking entities that are affiliated investment advisers, are there particular costs or benefits to complying with the portions of Appendix C that are applicable to each asset management unit of the adviser? Do these costs and benefits differ depending on whether the adviser complies with Appendix C individually or on an enterprise basis? Does the

rule provide sufficient clarify for how Appendix C applies to unregistered affiliates of an affiliated investment adviser?

Question [•]. To the extent applicable, please address each of the questions above with respect to securitization vehicles that would be included in the proposed definition of covered fund.

Commenters are asked to identify or estimate start-up, or non-recurring, costs separately from costs or effects they believe would be ongoing. Additionally, the Agencies request comment on the following questions:

VIII. Administrative Law Matters.

A. Paperwork Reduction Act Analysis.

Request for Comment on Proposed Information Collection

In accordance with section 3512 of the Paperwork Reduction Act of 1995 (“PRA”) (44 U.S.C. § 3501-3521), the Agencies may not conduct or sponsor, and a respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (“OMB”) control number. The OCC, FDIC, and Board will obtain OMB control numbers. The information collection requirements contained in this joint notice of proposed rulemaking, to the extent they apply to insured financial institutions that are not under a holding company, have been submitted by the OCC and FDIC to OMB for review and approval under section 3506 of the PRA and section 1320.11 of OMB’s implementing regulations (5 C.F.R. § 1320). The Board reviewed the proposed rule under the authority delegated to the Board by OMB. The Board will submit to OMB once the final rule is published and the submission will include, along with burden for Federal Reserve-supervised institutions, burden for OCC-, FDIC-, SEC-, and CFTC-supervised institutions under a holding company. The CFTC has stated that it will be publishing a separate proposed rulemaking in the near future. The burden estimates for CFTC-supervised institutions, published in this proposed rule, are based on the requirements set forth below and the assumption that the CFTC’s proposed rulemaking would contain substantively similar requirements.

The proposed rule contains requirements subject to the PRA. The reporting requirements are found in sections __.7(a) and __.12(e); the recordkeeping requirements are found in sections __.3(b)(2)(iii)(C), __.5(c), __.7(a), __.11(b), __.13(b)(3), __.20(b), __.20(c), and __.20(d); and the disclosure requirements are found in sections __.11(h)(1) and __.17(b)(1). The recordkeeping burden for the following sections is accounted for in the __.20(b) burden: __.4(a)(2)(i), __.4(b)(2)(i), __.5(b)(1), __.5(b)(2)(i), __.5(b)(2)(v), __.13(b)(2)(i), __.13(b)(2)(ii)(A), __.13(b)(2)(ii)(D), and __.15(a)(1). These information collection requirements would implement section 619 of the Dodd-Frank Act, as mentioned in the Abstract

below. The respondent/recordkeepers are for-profit financial institutions, including small businesses. A covered entity must retain these records for a period that is no less than 5 years in a form that allows it to promptly produce such records to [Agency] on request.

Comments are invited on:

- (a) Whether the collections of information are necessary for the proper performance of the Agencies' functions, including whether the information has practical utility;
- (b) The accuracy of the estimates of the burden of the information collections, including the validity of the methodology and assumptions used;
- (c) Ways to enhance the quality, utility, and clarity of the information to be collected;
- (d) Ways to minimize the burden of the information collections on respondents, including through the use of automated collection techniques or other forms of information technology; and
- (e) Estimates of capital or start up costs and costs of operation, maintenance, and purchase of services to provide information.

All comments will become a matter of public record. Comments on aspects of this notice that may affect reporting, recordkeeping, or disclosure requirements and burden estimates should be sent to the addresses listed in the ADDRESSES section of this Supplementary Information. A copy of the comments may also be submitted to the OMB desk officer for the Agencies: By mail to U.S. Office of Management and Budget, 725 17th Street, NW, #10235, Washington, DC 20503 or by facsimile to 202-395-5806, Attention, Commission and Federal Banking Agency Desk Officer.

Proposed Information Collection

Title of Information Collection: Reporting, Recordkeeping, and Disclosure Requirements Associated with Restrictions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds.

Frequency of Response: Annual, monthly, and on occasion.

Affected Public: Businesses or other for-profit.

Respondents:

Board: State member banks, bank holding companies, savings and loan holding companies, mutual holding companies, foreign banking organizations, and other holding companies that control an insured depository institution. In addition, the Board will take burden for all institutions under a holding company including:

- OCC-supervised institutions;

- FDIC-supervised institutions;
- CFTC registered swap dealers, future commission merchants, commodity trading advisors, and commodity pool operators; and
- Any banking entity for which the SEC is the primary financial regulatory agency, as defined in section 2(12)(B) of the Dodd-Frank Act.

OCC: National banks, federal savings associations, and federal savings banks not under a holding company, and their respective subsidiaries, and their affiliates not under a holding company. The OCC will take the burden with respect to registered investment advisers affiliated with national banks, federal savings associations, and federal savings banks not under a bank holding company.

FDIC: State nonmember banks not under a holding company; state savings associations and state savings banks not under a holding company; subsidiaries of state nonmember banks, state savings associations and state savings banks not under a holding company; and foreign banks having an insured branch.

Abstract: Section 619 of the Dodd-Frank Act added a new section 13 to the BHC Act (to be codified at 12 U.S.C. § 1851) that generally prohibits any banking entity from engaging in proprietary trading or from investing in, sponsoring, or having certain relationships with a hedge fund or private equity fund, subject to certain exemptions. New section 13 of the BHC Act also provides for nonbank financial companies supervised by the Board that engage in such activities or have such investments or relationships to be subject to additional capital requirements, quantitative limits, or other restrictions. Although section 13 of the BHC Act does not include any express statutory statement of purpose or legislative intent, it appears that the purpose of section 13 is to prohibit proprietary trading at banks while permitting banks to continue to engage in client-oriented financial services.

Section __.3(b)(2)(iii)(C) would require a covered banking entity to establish a documented liquidity management plan in order to rely on an exclusion from the definition of “trading account” for certain positions taken for the bona fide purpose of liquidity management.

Section __.5(c) would require that, with respect to any purchase, sale, or series of purchases or sales conducted by a covered banking entity pursuant to section __.5 for risk-mitigating hedging purposes that is established at a level of organization that is different than the level of organization establishing the positions, contracts, or other holdings the risks of which the purchase, sale, or series of purchases or sales are designed to reduce, the covered banking entity document, at the time the purchase, sale, or series of purchases or sales are conducted:

- (1) The risk-mitigating purpose of the purchase, sale, or series of purchases or sales;
- (2) The risks of the individual or aggregated positions, contracts, or other holdings of a covered banking entity that the purchase, sale, or series of purchases or sales are designed to reduce; and
- (3) The level of organization that is establishing the hedge.

Sections __.7(a) would require a covered banking entity engaged in any proprietary trading activity pursuant to sections __.4 through __.6 to comply with the reporting and recordkeeping requirements described in Appendix A if the covered banking entity has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than \$1 billion, as well as such other reporting and recordkeeping requirements as a relevant Agency may impose to evaluate the covered banking entity's compliance with this subpart.

Section __.11(b) would require that, with respect to any covered fund that is organized and offered by a covered banking entity in connection with the provision of bona fide trust, fiduciary, investment advisory, or commodity trading advisory services and to persons that are customers of such services of the covered banking entity, the covered banking entity document how the covered banking entity intends to provide advisory or similar services to its customers through organizing and offering such fund.

Section __.11(h)(1) would require that, with respect to any covered fund that is organized and offered by a covered banking entity in connection with the provision of bona fide trust, fiduciary, investment advisory, or commodity trading advisory services and to persons that are customers of such services of the covered banking entity, the covered banking entity clearly and conspicuously disclose, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents):

- (1) That "any losses in [such covered fund] are borne solely by investors in [the covered fund] and not by [the covered banking entity and its affiliates or subsidiaries] and that any losses in [such covered fund] that will be borne by [the covered banking entity and its affiliates or subsidiaries] are limited to the ownership interest in the covered fund held by the [covered banking entity and its affiliates or subsidiaries]";
- (2) That such investor should read the fund offering documents before investing;
- (3) That the "ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity" (unless that happens to be the case); and
- (4) The role of the covered banking entity or its affiliates, subsidiaries or employees in sponsoring or providing any services to the covered fund.

Section __.12(e) would extend the time to divest an ownership interest in a covered fund. Upon receipt of an application from a covered banking entity, the Board may extend the period of time to meet the requirements under paragraphs (a)(2)(i)(A) and (B) of that section for up to 2 additional years, if the Board finds that an extension would be consistent with safety and soundness and not detrimental to the public interest. An application for extension must:

- (i) Be submitted to the Board at least 90 days prior to the expiration of the applicable time period;

(ii) Provide the reasons for application, including information that addresses the factors in paragraph (e)(2) of that section; and

(iii) Explain the covered banking entity's plan for reducing the permitted investment in a covered fund through redemption, sale, dilution or other methods as required in paragraph (a)(2)(i) of that section.

Section __.13(b)(3) would require that, with respect to any acquisition or retention of an ownership interest in a covered fund by a covered banking entity pursuant to § __.13(b), the covered banking entity must document, at the time the transaction is conducted:

- (1) The risk-mitigating purpose of the acquisition or retention of an ownership interest in a covered fund;
- (2) The risks of the individual or aggregated obligation or liability of a covered banking entity that the acquisition or retention of an ownership interest in a covered fund is designed to reduce; and
- (3) The level of organization that is establishing the hedge.

Section __.17(b)(1) would require investment advisers, commodity trading advisers, and commodity pool operators to make clear, timely, and effective disclosure of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest; and would make such disclosure explicitly and effectively, and in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest.

Section __.20(b) would require a compliance program with respect to covered fund activities and investments that shall, at a minimum, include:

- (1) Internal written policies and procedures reasonably designed to document, describe, and monitor the covered trading and covered fund activities and investments of the covered banking entity to ensure that such activities and investments are compliant with section 13 of the BHC Act and this part;
- (2) A system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with section 13 of the BHC Act and this part in the covered banking entity's covered trading and covered fund activities and investments and to prevent the occurrence of activities or investments that are prohibited by section 13 of the BHC Act and this part;
- (3) A management framework that clearly delineates responsibility and accountability for compliance with section 13 of the BHC Act and this part;
- (4) Independent testing for the effectiveness of the compliance program conducted by qualified personnel of the covered banking entity or by a qualified outside party;

(5) Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and

(6) Maintenance of records sufficient to demonstrate compliance with section 13 of the BHC Act and this part, which a covered banking entity must promptly provide to the Agency upon request and retain for a period of no less than 5 years.

Section __.20(c) would require the compliance program of a covered banking entity to also comply with the requirements and other standards contained in Appendix C if the covered banking entity: (i) engages in proprietary trading and has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters (A) is equal to or greater than \$1 billion, or (B) equals 10 percent or more of its total assets; or (ii) invests in, or has relationships with, a covered fund and (A) the covered banking entity has, together with its affiliates and subsidiaries, aggregate investments in one or more covered funds, the average value of which is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than \$1 billion, or (B) sponsors and advises, together with its affiliates and subsidiaries, one or more covered funds, the average total assets of which are, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than \$1 billion.

Section __.20(d) would require a covered banking entity that does not engage in activities or investments prohibited or restricted in subpart B or subpart C of the proposed rule, in order to be deemed to have satisfied the requirements of § __.20, to ensure that its existing compliance policies and procedures include measures that are designed to prevent the covered banking entity from becoming engaged in such activities or making such investments and which require the covered banking entity to develop and provide for establishment of the compliance program required under § __.20(a) of the proposed rule prior to engaging in such activities or making such investments.

Estimated Paperwork Burden

In determining the method for estimating the paperwork burden the Agencies made the assumption that affiliated entities under a holding company would act in concert with one another to take advantage of efficiencies that may exist. The Agencies invite comment on whether it is reasonable to assume that affiliated entities would act jointly to implement a firm-wide program or whether they would act independently to implement programs tailored to each entity.

Estimated Burden per Response:

Section __.3(b)(2)(iii)(C) recordkeeping – 1 hour (Initial setup 3 hours).

Section __.5(c) recordkeeping – 6 hours for entities with \$1 billion or more in trading assets/liabilities, 35 hours for entities with \$5 billion or more in trading assets/liabilities.

Section __.7(a) reporting – 2 hours for entities with \$1 billion or more in trading assets/liabilities, 2 hours for entities with \$5 billion or more in trading assets/liabilities (Initial

setup 6 hours for entities with \$1 billion or more in trading assets/liabilities, 6 hours for entities with \$5 billion or more in trading assets/liabilities).

Section __.7(a) recordkeeping – 350 hours for entities with \$1 billion or more in trading assets/liabilities, 440 hours for entities with \$5 billion or more in trading assets/liabilities.

Section __.11(b) recordkeeping – 10 hours.

Section __.11(h)(1) disclosure – 0.10 hours.

Section __.12(e) reporting – 20 hours (Initial setup 50 hours).

Section __.13(b)(3) recordkeeping – 10 hours.

Section __.17(b)(1) disclosure – 2 hours.

Section __.20(b) recordkeeping – 265 hours (Initial setup 795 hours).

Section __.20(c) recordkeeping – 1,200 hours (Initial setup 3,600 hours).

Section __.20(d) recordkeeping – 8 hours.

Board

Number of respondents: 10,000.

Total estimated annual burden: 6,284,620 hours (4,541,570 hours for initial setup and 1,743,050 hours for ongoing compliance).

OCC

Number of respondents: 469.

Total estimated annual burden: 253,796 hours (187,643 hours for initial setup and 66,153 hours for ongoing compliance).

FDIC

Number of respondents: 1,139.

Total estimated annual burden: 46,428 hours (29,934 hours for initial setup and 16,494 hours for ongoing compliance).

B. Initial Regulatory Flexibility Act Analysis

The Regulatory Flexibility Act, 5 U.S.C. 601 et seq., requires an agency to consider whether the rules it proposes will have a significant economic impact on a substantial number of

small entities.³⁶⁵ If so, the agency must prepare an initial and final regulatory flexibility analysis respecting the significant economic impact. Pursuant to section 605(b) of the RFA, the regulatory flexibility analysis otherwise required under sections 603 and 604 of the RFA is not required if an agency certifies that the rule will not have a significant economic impact on a substantial number of small entities. The Agencies have considered the potential impact of the proposed rule on small entities in accordance with the Regulatory Flexibility Act. The proposed rule would not appear to have a significant economic impact on small entities for several reasons.

First, while the proposed rule will affect all banking organizations, including those that have been defined to be “small businesses” under the RFA, only certain limited requirements would be imposed on entities that engage in little or no covered trading activities or covered fund activities and investments. Significantly, the reporting and recordkeeping requirements of § 7 and Appendix A of the proposed rule apply only to banking entities with average trading assets and liabilities on a consolidated, worldwide basis equal to or greater than \$1 billion for the preceding year. This is a threshold that a small banking entity typically would not meet.

Second, the scope and size of the compliance program requirements set forth in subpart D and Appendix C of the proposed rule would vary based on the size and activities of each covered banking entity. Only banking entities with average trading assets and liabilities on a worldwide consolidated basis equal to or greater than \$1 billion or 10 percent or more of their total assets, or that have aggregate investments in, or sponsor or advise, covered funds with aggregate total assets of more than \$1 billion must establish, maintain and enforce a full compliance program under the proposed rule. Banking entities that engage in trading activities or covered fund activities and investments under these thresholds must adopt, at a minimum, only the six core compliance requirements set forth in § 20 of the proposed rule. Banking entities that do not engage in any covered trading or fund activities, typical of small banking entities, must ensure only that their compliance programs include measures designed to prevent the entities from becoming engaged in covered activities unless they first adopt a compliance program. These compliance requirements would not appear to have a significant economic impact on a substantial number of small entities.

OCC, FDIC, and SEC: For the reasons stated above, the head of each of the OCC, FDIC, and SEC certifies, for the covered banking entities subject to each such Agency’s jurisdiction, that the proposed rule would not result in a significant economic impact on a substantial number of small entities. The OCC, FDIC, and SEC encourage written comments regarding this certification, and request that commenters describe the nature of any impact on small entities and provide empirical data to illustrate and support the extent of the impact.

Board: For the reasons stated above, the proposed rules would not appear to have a significant economic impact on small entities subject to the Board’s jurisdiction. The Board welcomes written comments regarding this initial regulatory flexibility analysis, and requests

³⁶⁵ A banking organization is generally considered to be a small banking entity for the purposes of the RFA if it has assets less than or equal to \$175 million. See also 13 CFR § 121.1302(a)(6) (noting factors that the Small Business Administration considers in determining whether an entity qualifies as a small business, including receipts, employees, and other measures of its domestic and foreign affiliates).

that commenters describe the nature of any impact on small entities and provide empirical data to illustrate and support the extent of the impact. A final regulatory flexibility analysis will be conducted after consideration of comment received during the public comment period.

C. OCC Unfunded Mandates Reform Act of 1995 Determination Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104-4 (2 U.S.C. 1532) (Unfunded Mandates Act), requires that an agency prepare a budgetary impact statement before promulgating any rule likely to result in a Federal mandate that may result in the expenditure by state, local, and tribal governments, in the aggregate, or by the private sector of \$100 million or more, as adjusted by inflation, in any one year. If a budgetary impact statement is required, Section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule.

The OCC has completed an assessment whether any mandates imposed by the proposed rule may result in expenditures of \$100 million or more annually, as adjusted by inflation, by state, local, and tribal governments, or by the private sector as required by the Unfunded Mandates Act. The OCC focused its analysis on the impact of the various compliance, recordkeeping, reporting, disclosure, and training requirements in the proposed rule and, as provided for under section 201 of the Unfunded Mandates Act (2 U.S.C. 1531), excluded the cost of requirements specifically set forth in the statute. Overall, the OCC determined that this proposed rule will not result in expenditures by state, local, and tribal governments, or by the private sector, of \$100 million or more in any one year. Accordingly, this proposal is not subject to Section 202 of the Unfunded Mandates Act.

The OCC also will need to prepare an impact statement for the final rule, for purposes of the Unfunded Mandates Act and the Congressional Review Act, Pub. L. 104-121 (5 U.S.C. §§801-808). Comments provided on the costs and benefits of the proposed rule, in response to the analysis and questions posed in the Supplemental Information Part VII.D, will help to inform this assessment.